S. HRG. 98-150—PART 2

MANAGEMENT OF THE DEPARTMENT OF DEFENSE

HEARING

BEFORE THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

PART 2

DEFECTIVE PRICING UNDER THE TRUTH-IN-NEGOTIATIONS ACT

APRIL 14, 1983

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CONTENTS

Page

- Opening statements:
  - Senator Roth ... 1
  - Senator Cohen ... 73
  - Senator Levin ... 76

WITNESSES

Thursday, April 14, 1983

- James P. Viola, auditor, General Accounting Office staff, Dallas, Tex., assigned to the U.S. Senate Committee on Governmental Affairs ... 9
- Harvey J. Gordon, Assistant Deputy Under Secretary for Acquisition, Department of Defense; Charles O. Starrett, Jr., Director, Defense Contract Audit Agency; and Derek J. Vander Schaaf, Acting Deputy Inspector General, Office of the Inspector General, Department of Defense ... 57
- Harris J. Andrews, Jr., chairman, Armed Services Board of Contract Appeals, Alexandria, Va.; and Donald J. Kinlin, Senior Trial Attorney, U.S. Air Force, Wright-Patterson Air Force Base, Ohio ... 197

Alphabetical List of Witnesses

- Andrews, Harris J., Jr.:
  - Testimony ... 197
  - Prepared statement ... 206
- Gordon, Harvey J.:
  - Testimony ... 57
  - Prepared statement ... 87
  - Responses to written questions submitted by Senator Roth ... 115
- Kinlin, Donald J.:
  - Testimony ... 197
  - Prepared statement ... 210
  - Responses to written questions submitted by Senator Roth ... 235
  - Armed Services procurement regulations ... 240
  - "Accounting Court—An Idea Whose Time Has Come," National Contract Management Journal, vol. 15, 1982 ... 250
  - Report on "Defective Pricing" ... 256
- Starrett, Charles O., Jr.:
  - Testimony ... 57
  - Prepared statement ... 142
  - Responses to written questions submitted by Senator Roth ... 152
- Vander Schaaf, Derek J.:
  - Testimony ... 57
  - Defective pricing contract price adjustments recommended by the Defense Contract Audit Agency and negotiated by contracting officers for the years 1966 through 1982 (table) ... 67
  - Prepared statement ... 171
  - Responses to prehearing questions asked of Joseph Sherick, Acting Inspector General, Department of Defense ... 188
- Viola, James P.:
  - Testimony ... 9
  - Reports presenting a summary of reviews and statistical findings of defective pricing ... 12

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Page

Charts:
  - Defense Department budget outlays 4
  - Proportion of Defense Department procurement actions awarded competitively through advertising and awarded noncompetitively through negotiations 5
  - Department of Defense contract price adjustments recommended and negotiated as a result of defective pricing reviews 6
  - Contract price adjustments recommended and negotiated as a result of audits of contractors' pricing proposals under $500,000 each 7

Letter, with enclosure, to Caspar W. Weinberger, Secretary of Defense, from Senator William V. Roth, Jr., June 8, 1983 283

MANAGEMENT OF THE DEPARTMENT OF DEFENSE

THURSDAY, APRIL 14, 1983

U.S. Senate,
Committee on Governmental Affairs,
Washington, D. C.

The committee met at 9:30 a.m., in room SD–342, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Present: Senators Roth, Cohen, Rudman, Nunn, Levin, and Bingaman.

OPENING STATEMENT OF SENATOR ROTH

Chairman Roth. The committee will please be in order.

Today, the Committee on Governmental Affairs continues the series of hearings on Defense Department Management, which we began on March 23d.

The purpose of today's hearing is to investigate the problem of defective pricing. We are concerned that Government contractors may be receiving overpayments because they have submitted inadequate cost data on negotiated sole source contracts.

I have a full statement which I will not read but will be included as part of the record.

[The prepared statement of Senator Roth follows:]

Prepared Statement of Senator Roth

Today, The Commmittee on Governmental Affairs continues the series of hearings on Defense Department management which we began on March 23d. The committee will examine the Department's record in detecting and ensuring that contractors pay the Government back for overcharges resulting from defectively priced, negotiated sole-source contracts in accordance with intent of the Truth-in-Negotiations Act, Public Law 87–653.

As I said in our first hearing, the consensus for added defense spending is eroding. I need not review the polls which reveal this significant decline in public support for more increases in the defense budget, but it is plain the public does not believe its' defense dollars are being spent wisely or efficiently. The public's support is not irretrievably lost, in my view, but they need to be convinced the Defense programs can be managed efficiently. The sorry state of the Truth-in-Negotiations Act which we will examine today demonstrates that we have much to do to earn the public's trust.

The President's budget for fiscal year 1984 calls for Defense Department outlays of $238.6 billion, including about $94 billion for weapon system acquisitions. Based on prior experience, over $80 billion, or 86 percent of this money will be spent on research and development and procurement contracts.

By and large, these contracts will not be awarded competitively to the lowest bidder. Even though many studies indicate that competition can save up to 30 percent of the costs of most contracts, most of these funds will be spent instead through negotiations with individual contractors on a sole-source basis.

About $67 billion, or 71 percent of this procurement money will end up in negotiated, sole-source contracts costing over $500,000 each. It is these contracts, in particular, that will be the focus of our attention in today's hearing because they are subject to the defective pricing provisions of Public Law 87-653, the Truth-in-Negotiations Act.

The Truth-in-Negotiations Act was passed in 1962. It was enacted in response to several General Accounting Office audits which disclosed that Defense contractors were making excessive profits on negotiated, sole-source contracts. The lack of competition for these contracts meant that there was very little incentive to hold down costs. Because there was no competition, government had to rely on good faith negotiations with the contractor to ensure the lowest possible price.

All too often, the deck was stacked against the Government in these negotiations. Contractors were not required by law to supply all available pricing information to the Government, and in many cases contractors actually had more current, accurate and complete information indicating they would incur lower material, labor and other costs than they were using to support their contract pricing proposals. As a result, negotiated contract prices were too high and contractors profits were frequently exorbitant.

The Truth-in-Negotiations Act was supposed to put Government procurement officials on an equal footing with contractors when negotiating sole-source contracts. In a sense, it was designed to be a partial substitute for the lack of competition on these contracts.

The law requires contractors to submit current, accurate and complete cost and pricing data and to certify to that fact. It also authorizes the Government to audit the records of these contractors to find out whether they had, but failed to submit, better and more accurate cost and pricing data. Under the law, the procurement officials involved can reduce the contract price or recover contractual overpayments if a post-award audit discloses defective prices.

With a law like this on the books, overcharges on contracts should be under control. Unfortunately, during the 20 years in which the law has been in effect, the Defense Department has managed to pull, break or grind down most of the meager teeth the law had.

New defense procurement policies have narrowed its application by raising the thresholds over which the law applies. Limited and sometimes poor contract audit work has provided inadequate support for defective pricing findings. Government procurement officials have weakened its effectiveness by not promptly acting on and sustaining valid defective pricing audit findings. Some of the decisions of the armed services board of contract appeals may have reduced even further the effectiveness of the law in reducing contract costs. In short, everyone involved, including the Congress bears some responsibility for the ineffectiveness of the law in eliminating contract overcharges.

To top it all off, until now, there has been little, if any, congressional or Defense Department oversight of the defective pricing law in the past 20 years. The protection intended to be provided by the Truth-in-Negotiations Act has been reduced to a crumpled fig leaf. It provides few disincentives to submitting faulty and overcharged contract proposals. Contractors who submit defective pricing data have long-term use of the taxpayers' money, and pay no interest or penalties for doing so. Contract auditors give a low priority, applying less than 3 percent of their resources, to defective pricing audits. Finally, contracting officers and their trial attorneys frequently seek reduced settlements, sustaining only 14 percent of the auditors' findings, to avoid, in some cases, less favorable decisions by the appeals board.

The audits done for the committee on actual defective pricing cases provide numerous examples of the waste of tax dollars through contract overcharges. In one case, involving over two million dollars in overcharges, it took more than three years after the contractor agreed that he owed the government money, for a settlement to be reached. No interest charges were ever paid by the contractor during this three year period and the government did not use other means, such as withholding progress payments on other contracts, to force the company to pay what it owed.

In another case, DCAA found $165,000 of overcharges on a contract. While the contracting officer agreed that there was a defective pricing violation, he concluded that the amount involved was "not significant" and declined to try to collect from the contractor. I don't believe $165,000 should be small pocket change in anyone's book especially now when we are trying to reduce the towering deficits we face in coming years.

As a result of this mismanagement the Defense Department wastes about a half billion dollars annually in excessive contract prices and overcharges. Even worse is the immeasurable adverse impact caused by the absence of any real deterrent to contractors' defective pricing violations, whether intentional or not.

Several actions must be taken quickly to stop this tragic waste of money. The Truth-in-Negotiations Act needs to be clarified and strengthened to assure that, regardless of the size of the negotiated price, contractors have sufficient incentives for submitting current, accurate and complete cost and pricing data and discouraged from committing defective pricing violations.

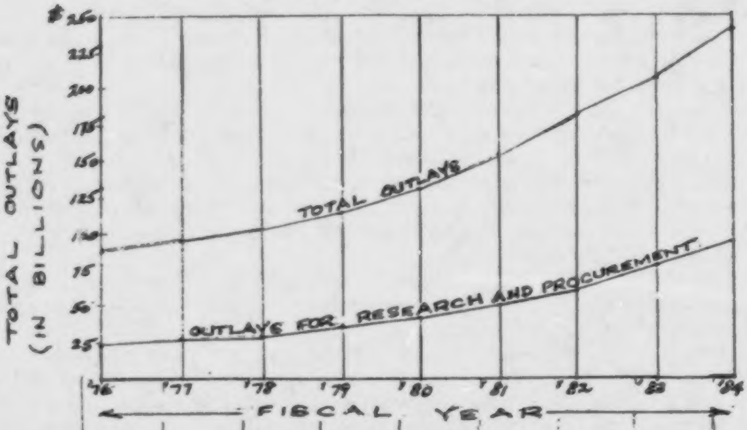
Even more importantly, the Defense Department procurement policy makers, contract auditors, contracting officers, trial attorneys, and their departmental overseers must take aggressive action to improve the efficiency and effectiveness of their activities in Defense Department defective pricing matters. Then, and only then, can we hope to restore the public's support for the orderly rebuilding of our nation's defense forces. We must show the public that the Pentagon can spend these huge sums of new money efficiently.

The committee asked four GAO auditors to assist us in gathering data for this hearing. I want to emphasize that they are not representing the GAO, but worked under the direction of the committee.

I would like to ask Mr. James Viola, one of the four auditors who assisted the committee by examining defective pricing audits and related negotiations at selected contractor and Defense Department locations, to present the summary results of those examinations. I ask unanimous consent to insert the four audit reports into the hearing record.

DEFENSE DEPARTMENT BUDGET OUTLAYS

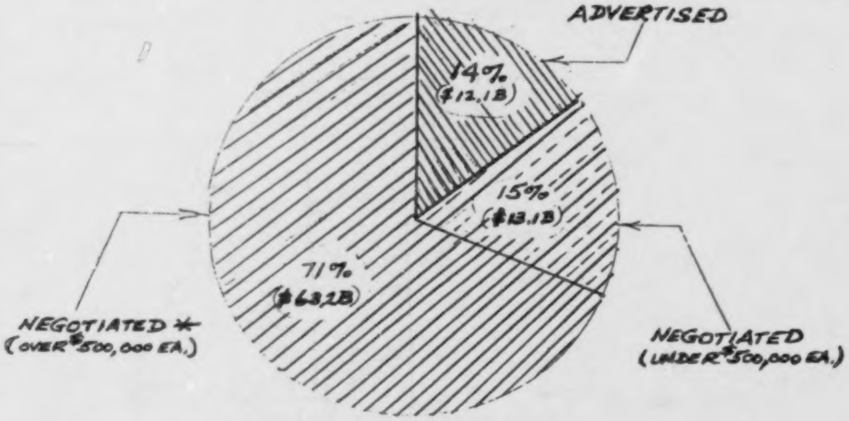
(ACTUALS FOR FY 1976-FY 1982; ESTIMATES FOR FY 1983 AND FY 1984)



(AMOUNTS IN BILLIONS)

• RESEARCH AND PROCUREMENT	$24.9	$28.0	$28.1	$36.6	$42.1	$50.5	$61.0	$76.6E	$94.6E
• ALL OTHER OUTLAYS	63.0	67.6	74.9	78.4	90.7	105.6	121.9	132.3E	144.0E
• TOTALS	$87.9	$95.6	$103.0	$115.0	$132.8	$156.1	$182.9	$208.9E	$238.6E

PROPORTION OF DEFENSE DEPARTMENT PROCUREMENT ACTIONS AWARDED COMPETITIVELY THROUGH ADVERTISING AND AWARDED NONCOMPETITIVELY THROUGH NEGOTIATIONS



VOLUME OF PROCUREMENT ACTIONS (IN BILLIONS)

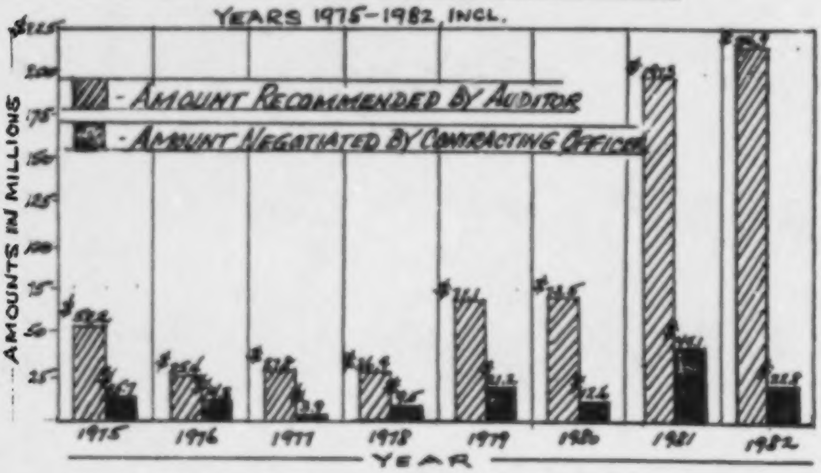
NEGOTIATED	FY 81 ACTUALS	FY 84 FORECAST %	FY 84 FORECAST AMOUNT
UNDER $500,000	$ 13.1	15%	$ 14.2
OVER $ 500,000	63.2 *	71%	67.2*
NEGOTIATED AMOUNT	76.3	86%	81.4
ADVERTISED	12.1	14%	13.2
TOTALS	$ 88.4	100%	$ 94.6

* AMOUNT SUBJECT TO THE DEFECTIVE PRICING LAW

DEPARTMENT OF DEFENSE

CONTRACT PRICE ADJUSTMENTS RECOMMENDED AND NEGOTIATED AS A RESULT OF DEFECTIVE PRICING REVIEWS

YEARS 1975-1982, INCL.



CONTRACT PRICE ADJUSTMENTS RECOMMENDED AND NEGOTIATED AS A RESULT OF AUDITS OF CONTRACTORS' PRICING PROPOSALS UNDER $500,000 EACH - FOR THE YEARS 1981 AND 1982

	YR.1981	YR.1982
	($ AMOUNTS IN MILLIONS)	
BASED ON NUMBER OF CONTRACTORS' PRICING PROPOSALS AUDITED	11,851	10,358
A. PROPOSED COSTS QUESTIONED BY AUDITORS	$ 247.6	$ 256.4
B. QUESTIONED COSTS SUSTAINED BY CONTRACTING OFFICERS	$ 131.4	$ 173.6
C. COST TO CONDUCT THESE AUDITS OF CONTRACTORS' PRICING PROPOSALS	$ 9.5	$ 8.6
RATIO OF COST SAVINGS (B) TO AUDIT COST (C)	14 To 1	20 To 1

Chairman ROTH. Let me just make a few observations. We are all aware, of course, that under the law our preferred method of procurement is through competition. It is estimated that competition can save up to 30 percent of the cost of most contracts.

Despite the fact that this is a legal requirement, we are also faced with the fact that roughly 71 percent of the procurement money, or in the current year about $67 billion, will end up in negotiated sole source contracts costing over $500,000 each.

It was back in 1962 that the so-called Truth-in-Negotiations Act was passed to require the contractors to submit current, accurate and complete cost and pricing data and to certify to that fact on negotiated contracts.

It also authorized the Government to audit the records of these contractors to find out whether they had, but failed to submit, better and more accurate cost and pricing data. Under the law the procurement official involved can reduce the contract price or recover contractual overpayments if a post-award audit discloses defective prices. This law came about as a result of some work done by the General Accounting Office which showed that at least some contractors were making excessive profits on negotiated sole source contracts.

The lack of competition for these contracts meant that there was very little incentive to hold down costs. Because there was no competition for these contracts, the Government had to rely on good faith negotiations with the contractor to insure the lowest possible price.

In any event, the General Accounting Office report showed that negotiated contract prices were too high and contractor profits were frequently exorbitant. So the truth-in-negotiations legislation was enacted in the hopes that it would bring the situation under control.

I think the act is a poor substitute for competition at best. But our investigation has shown that, unfortunately, the Defense Department has managed to pull, break or grind down most of the meager teeth the law had.

New defense procurement policies have narrowed its application by raising the threshholds over which the law applies. Limited and sometimes poor contract audit work has provided inadequate support for defective pricing findings. Government procurement officials have weakened its effectiveness by not promptly acting on and sustaining valid defective pricing audit findings.

Some of the decisions of the Armed Services Board of Contract Appeals may have reduced even further the effectiveness of the law in reducing contract costs.

In short, everyone involved, including the Congress, bears some responsibility for the ineffectiveness of the law in eliminating contract overcharges.

There has been practically no congressional oversight on this matter in the past 20 years. A law which has been reduced to a crumpled fig leaf provides few disincentives to submitting faulty and overcharged contract proposals. Contractors who submit defective pricing data have long term use of the taxpayer's money and pay no interest or penalties for doing so. Contract auditors are giving a low priority to the problem by applying less than 3 percent of their resources to defective pricing audits. Finally, contracting officers and their trial attorneys frequently seek reduced settlements sustaining only 14 percent of the auditor's finding to avoid, in some cases, unfavorable decisions by the Armed Services Board of Contract Appeals.

There are numerous examples of the waste of tax dollars through contract overcharges. One case involves something like $2 million in overcharges. It took more than 3 years after the contractor agreed that he owed the Government money for settlement to be reached. No interest charges were ever paid by the contractor during that period. There was no incentive to settle this case.

In another case, DCAA found $165,000 of overcharges on a contract. While the contracting officer agreed that there was a defective pricing violation, he concluded that $165,000 was not significant and declined to try to collect from the contractor. This is unbelievable when, during this very week, people are trying to make out their income tax returns. As a result of this mismanagement, it is estimated that the Defense Department wastes about half a billion dollars annually in excessive contract prices and overcharges. It is not an insignificant amount of money, even in a budget as large as that of the Pentagon.

We have asked four GAO auditors to assist in gathering data for this hearing. I want to emphasize that these individuals are not representing GAO, but are working under the direction of this committee.

At this time, I would be happy to call on my colleague, Senator Rudman, for any comments he may care to make.

Senator RUDMAN. Thank you, Mr. Chairman.

I don't have an opening statement this morning. I am looking forward to hearing the witness.

Chairman ROTH. Thank you.

We will then proceed to ask Mr. James Viola, one of the four auditors from GAO who assisted the committee by examining defective pricing audits, to come forward and to present the summary results of those examinations.

TESTIMONY OF JAMES P. VIOLA, AUDITOR, GENERAL ACCOUNTING OFFICE STAFF, DALLAS, TEX., ASSIGNED TO THE U.S. SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

Mr. VIOLA. Mr. Chairman, members of the committee, I am James Viola, a member of the General Accounting Office staff in Dallas, Tex.

It is my privilege to appear here today to formally submit to the committee a summary of the results of defective pricing oversight reviews conducted by myself and three other GAO auditors while on temporary assignment to this committee.

The objectives of the work were to determine the volume of defective pricing cases reported by the Defense Contract Audit Agency at selected locations, to determine the adequacy of DCAA audit work, and to evaluate actions taken by Government procurement officials in the settlement of defective pricing cases. The purpose of this work was to identify weaknesses in the audit and settlement process and to make suggestions for improvements in this process. Work was performed at four DCAA resident offices during the week of March 14–18, 1983: General Dynamics Corp., Fort Worth Division, Fort Worth, Tex.; Fairchild Republic Co., Farmingdale, N.Y.; McDonnell Douglas Corp., St. Louis, Mo.; and Grumman Aerospace Corp., Bethpage, Long Island, N.Y.

Work was also performed at Government procurement offices during the week of March 21–25, 1983: The Aeronautical Systems Division, Air Force Logistics Command, Wright-Patterson Air Force Base, Ohio, and the Naval Air Systems Command, Alexandria, Va. The evaluation of audit reports and contracting officer actions was made by reviewing the related decisions and actions on 18 recently closed defective pricing cases emanating from audit reports issued by those four DCAA offices.

As of March 14, 1983, there were 53 unresolved defective pricing reports totaling $152.2 million issued by the four DCAA offices visited. And, on the 18 closed cases reviewed, we found that DCAA questioned costs totaled $15.3 million and contracting officers settled for $4.5 million, roughly 29.5 percent of the total amount of defective pricing reported.

In our evaluation of the settlements of these cases, we observed a pattern of deficiencies that account for the difference between the total amount of defective pricing reported by the contract auditors and the eventual settlements by procuring officials. These deficiencies can be grouped into three categories, as follows:

Inadequate communications between DCAA auditors and Government negotiators;

Lack of timely settlement of cases; and,

Unfavorable dollar settlements.

In some instances, the amount of a reported defective pricing case was based on contractor proposed data that was not as current, complete, or accurate as the data the Government negotiator relied upon. This occurred because contractors provided updated proposal information to the Government negotiator after their original proposal and DCAA was not aware of the updated information. This situation occurred because the Government price negotiation memorandum did not contain sufficient detail to make the DCAA auditors aware of what data the Government negotiator actually used in contract negotiations.

Further, contractors are required to respond to the DCAA report. If the dollar findings are overstated, the difference between DCAA and the Government negotiator position result in numerous meetings and correspondence to resolve the issues. This would not be necessary if better coordination existed.

Several factors contributed to untimely settlements.

First, and perhaps the most important factor was that contractors have no financial incentive to settle cases because they usually have been paid, through contract deliveries and progress payments, the amount of the defective pricing violation. Thus, the longer a case remains unsettled, the longer a contractor holds onto the money.

Second, the longer a case remains unsettled, the weaker the Government's position tends to become for a favorable settlement through either negotiation or litigation.

Other factors relating to untimely settlement revolve around a lack of aggressiveness on the part of Government procurement officials. Some officials were reluctant to withhold payments from contractors while the case was open even though the contractor was not responsive to the DCAA report or did not demonstrate a willingness to settle the case.

One factor contributing to unfavorable dollar settlements is the lack of timeliness, as described above. Another factor is that unfavorable ASBCA decisions keep some cases from going to trial, even though the Government case has merit.

On one case, for example, the Government trial attorney decided to settle a case out of court for about 50 cents on the dollar, because of his concern that the ASBCA might reject the Government's case entirely. Another factor that results in fewer dollars being recovered by the Government is the practice of allowing contractors to propose offsets, that is, to let contractors look for errors or omissions in other aspects of the original proposal to offset the Government's defective pricing finding.

In my opinion, the conditions that existed in the settlement of reported defective pricing violations could be corrected in future settlements with a few changes in the Public Law and DOD policy.

DOD contract audit policy should require that coordination and communications between DCAA and Government procurement officials be improved so that defective pricing amounts reported by DCAA are in fact based on the data on which the Government negotiator relied. This would prevent the overstatement of defective pricing dollars reported by DCAA auditors and would increase the credibility of the Government's defective pricing cases.

Public Law 87-653 should require Government procurement officials to withhold progress payments from a contractor if a defective pricing case is not settled, or if a contractor is not responsive to the audit report, within a reasonable timeframe. The law should be amended to impose interest charges on the funds contractors hold up to the point in time when the case is settled. As long as there is no financial incentive for contractors to settle cases, settlement will not be a major priority.

The law should also be clarified regarding the allowability of offsets. Contractor offset proposals reduce defective pricing recoveries under the present system and compliance or delay case settlements.

Appendix A summarizes the statistical findings of the four reviews. Details of the work at the four locations are also attached.

Chairman ROTH. Thank you, Mr. Viola.

Do you have any questions, Senator Rudman?

Senator RUDMAN. I have no questions for this witness.

Chairman ROTH. We appreciate the help you and the other three auditors have given us.

[The four reviews and the statistical findings referred to follow:].

SUMMARY

REVIEW OF DEFENSE CONTRACT AUDIT AGENCY REPORTS ON DEFECTIVE PRICING AND AIR FORCE RESOLUTION

MCDONNELL AIRCRAFT COMPANY

MCDONNELL DOUGLAS CORPORATION

ST. LOUIS, MISSOURI

INTRODUCTION

In accordance with your verbal request, I have reviewed selected Defense Contract Audit Agency (DCAA) audits of defective pricing and the Department of the Air Force resolution of the defective pricing issues.

OBJECTIVES AND SCOPE

The objectives of my evaluation were to determine the (1) volume of DCAA reports on contractor defective pricing, (2) adequacy of DCAA audits, and (3) appropriateness of the resolution of defective pricing issues by the Air Force.

To accomplish these objectives, I visited the DCAA Resident Office at McDonnell Aircraft Company, McDonnell Douglas Corporation, St. Louis, Missouri; and procurement, pricing, and Judge Advocate offices at Headquarters Aeronautical Systems Division (ASD), Wright Patterson Air Force Base, Ohio, during the period March 14 through 24, 1983. I obtained a listing of reports issued by DCAA on defective pricing since October 1, 1980. I also obtained a listing of reports issued prior to October 1, 1980, for which the Air Force resolved the defective pricing amount between October 1, 1980, and October 1, 1981. The DCAA and I selected three audit reports from these listings to review to determine the adequacy of the audits and the appropriateness of the resolution of the defective pricing amounts by the Air Force.

RESULTS OF REVIEW

DCAA issued 19 audit reports on defective pricing amounting to $41,496,014 from October 1, 1980, through March 15, 1983. Contracting officers settled 10 of these defective pricing cases, which totaled $8,665,405, for $2,844,444. A listing of these reports is included in the Attachment. One DCAA report, issued on May 22, 1979, identified $124,345 in defective pricing. The contracting officer settled this defective pricing for $36,286 prior to October 1, 1981.

My review of the adequacy of three of the above reports and the appropriateness of the contracting officers' resolution of the cases showed the major difference in the reported amount and the amount settled for one case was due to DCAA not being fullv aware of the basis for the Air Force negotiations of the prime contract. I could not determine the adequacy of the DCAA reported amounts and the negotiated amounts for the other two cases because the Air Force settled these two cases and three other cases in a lump sum and did not document the amount and rationale for the defective pricing settlement for individual cases. Detailed information on the results of my review of the three cases follows.

DCAA Audit Report 3421-1A420023-001
Contract F33657-77-C-0200, P00354

The DCAA performed an audit to determine if defective pricing existed for engineering change proposal 450 which was added to contract F33657-77-C-0200 by modification P00354. The initial audit report, dated May 14, 1981, identified defective pricing amounting to $1,480,300. The final revised report dated April 6, 1982, identified $1,451,429 in defective pricing for this contract modification. On July 30, 1982, ASD negotiated a credit of $685,183 with the contractor for defective pricing on this modification.

The following table shows the DCAA, contractor, Air Force negotiation objective amounts, and amounts considered by the Air Force to be negotiated for this defective pricing case.

	DCAA ALLEGATION	CONTRACTOR RESPONSE	AIR FORCE OBJECTIVE	CONSIDERED NEGOTIATED
Air Vehicle CFE	$ 359,692	$ 49,551	$ 58,566	$ 34,044
AGE CFE	795,287	330,629	504,799	504,799
Subcontracts	23,616	0	15,507	15,507
Pres & Pack	14,936	5,911	9,086	9,086
Warranty	95,482	30,887	47,037	45,075
Cost	$1,289,013	$416,978	$634,995	$608,511
Profit	162,416	52,539	80,009	76,672
Price	$1,451,429	$469,517	$715,004	$685,183

The reasons for differences between the DCAA reported amount and the negotiated amount include:

Air vehicle contractor furnished equipment (CFE)

--$118,424 - DCAA reduced the contractor proposed amount by a factor to recognize that quotations from subcontractors would be reduced during negotiations for a firm price. However, the ASD had considered this factor and reduced the contractor's proposed price according to the price negotiation memorandum.

--$16,556 - The DCAA reported these non-recurring costs as being defective pricing because the costs were not required for contractor performance. The ASD considered negotiated amount did not include these costs according to the price negotiation memorandum.

--$224,712 - The DCAA reported this amount of defective pricing based on their comparison of the most current vendor quotations to the contractor proposed amounts. ASD's pre-negotiation position was $58,566. ASD believed $166,146 in reported defective pricing was not valid because (1) the considered negotiated amounts were less than the DCAA reported amounts, (2) credit defective pricing amounts were not allowed, and (3) it would have been unreasonable for the contractor to provide ASD with an updated subcontractor quote received 1 day prior to completion of negotiations.

ASD revised the $58,566 pre-negotiation defective pricing amount to $4,947 based on contractor information provided during negotiations. However, according to the price negotiation memorandum, the contractor offered $34,044 and ASD personnel accepted the offer.

Aerospace Ground Equipment CFE

The DCAA reported defective pricing amounting to $795,287 for contractor furnished aerospace ground equipment based on more current prices than those included in the original proposal. DCAA did not include a factor reducing quoted prices when firm prices would be negotiated. However, the price negotiation memorandum did include this decrement factor. ASD used updated quotes provided by the contractor, dated in March and April 1978, as compared to February quotes used by DCAA. ASD's use of a decrement factor and updated quotes resulted in a defective pricing amount of $504,799.

Subcontracts

DCAA reported defective pricing amounting to $23,616 for subcontracts based on more current purchase order prices. ASD used their considered negotiated value for the subcontract rather than the purchase order value in computing defective pricing of $15,507.

Preservation, packing, and warranty cost and profit

The difference in dollar amounts for these costs and profit is due to the varying base costs used by the DCAA and ASD.

Adjustment to contract for defective pricing settlement

The Air Force negotiated an agreement with the contractor to adjust a contract other than F33657-77-C-0200 for the amount of defective pricing. Since contract F33657-77-C-0200 is a fixed price incentive type contract, the Air Force calculated the Government's share of the defective pricing amount of $685,183 to be $228,800. The Air Force and the contractor agreed the contractor would perform additional work amounting to $324,697 under a fixed price contract for the $228,800 in defective pricing.

Conclusion

It appears the Air Force negotiated a fair amount for defective pricing under contract F33657-77-C-0200, engineering change proposed 450. Generally, the difference between the DCAA reported and the ASD amounts of defective pricing was caused by (1) DCAA using a decrement factor for reducing contractor quotes which had been considered by the Air Force in negotiating the original contract modification, (2) the Air Force using more current pricing information than DCAA, (3) the DCAA reporting defective pricing amounts which were more than the Air Force negotiated amounts, (4) the Air Force not recognizing credit amounts to defective pricing adjustments, and (5) the Air Force believing it was not reasonable to expect the contractor to provide an updated quotation received 1 day prior to completion of negotiations. This information was not available in the price negotiation memorandum pertaining to the negotiation of the amount for the prime contract. Therefore, the DCAA was not aware of the factors considered by the Air Force which resulted in the issuance of an invalid defective pricing report. It appears better communication between the DCAA and ASD would have prevented this situation.

DCAA Audit Report 3421-9A420003-001
CONTRACT F33657-77-C-0200 and
DCAA Audit Report 3421-9A420007-001
Contract F33657-76-C-0464

ASD and the Staff Judge Advocate, Air Force Logistics Command, settled five defective pricing cases with McDonnell Aircraft Company, McDonnell Douglas Corporation, on December 29,

1982. The five cases had been appealed to the Armed Service Board of Contract Appeals by the contractor. These five cases of defective pricing pertained to fixed price incentive contracts. The defective pricing for the five cases totaled $15,596,330. The Air Force settled all cases for a lump sum of $2,000,000. The Air Force computed a total effect to Government contracts of $4,679,173 if the total $15,596,330 had been settled as defective pricing. Therefore, the Air Force negotiated a settlement of 42.7 percent of the reported defective pricing.

According to Air Force officials, they are not adjusting the affected contracts for the settled amount because current limitation of payment reports indicate that total billings and payments are less than total estimated prices of the items delivered. They are adjusting another contract for the settled amount.

Air Force officials did not prepare documentation on the rationale for the final settlement. Staff Judge Advocate attorneys stated it is not their policy to prepare this documentation. According to the attorneys, the settlement amount was based on several factors including the amount of supportable defective pricing, contractor offsets, and the risk of litigation. They stated an amount related to each factor is unknown.

The contract files included memorandums of meetings with Government personnel and negotiation sessions with contractor personnel. However, support for the amount negotiated was not prepared.

Of the five cases, DCAA selected the following audit reports of defective pricing for my review to determine the adequacy of the audit and Air Force negotiation.

Audit Report number	Contract number	Amount of defective pricing
3421-9A420003-001	F33657-77-C-0200	$4,635,278
3421-9A420007-001	F33657-76-C-0464	1,311,079

Each report included defective pricing for material, contractor furnished equipment, and major subcontracts.

The contracting officer issued final decisions for report 3421-9A420003-001 and 3421-9A420007-001 on September 12, 1980, and April 16, 1981, respectively, for the amount of defective pricing included in the audit reports. As stated previously, the Air Force negotiated a $2,000,000 adjustment for five cases, including the above two cases. The Air Force did not negotiate an adjustment for each case. They allocated the adjustment to each case based on the ratio of the $2,000,000 settlement to the total adjustment of $4,679,173 if the total reported defective pricing had been settled. Therefore, based on this ratio, the Air Force considered the following amounts of reported defective pricing and settlement pertained to the two cases reviewed:

Audit report number	Reported defective pricing sustained	Amount of settlement
3421-9A420003-001	$1,979,264	$567,145
3421-9A420007-001	$ 559,831	$172,906

The completion of negotiations for the settlement of these two cases required a lengthy period of time, 3 years 5 months and 2 years 5 months, as indicated below:

DCAA report		Date of	Date of
Number	Date	final decision	settlement
3421-9A420003-001	8/3/79	9/12/80	12/29/82
3421-9A420007-001	8/2/80	4/6/81	12/29/82

Contracting officer documents indicate the contractor was slow in providing responses which delayed a decision on the defective pricing issue for both contracts.

Conclusion

The Air Force settled the two defective pricing cases reported in DCAA advisory reports 3421-9A420003-001 and 3421-9A420007-001 with three other cases on defective pricing in a lump sum and did not document their basis for the settlement. Therefore, a conclusion as to adequacy of the DCAA reported defective pricing or Air Force settlement could not be reached.

DCAA And Air Force Recommendations For Improving Process For Reporting And Negotiating Defective Pricing Issues

DCAA and Air Force officials stated a review of contractor offsets is needed to determine if the Congress intended these offsets to be allowable under Public Law 87-653. They indicate long delays occur in settling the defective pricing issues because of the time required for DCAA and contracting officer review of the proposed offsets.

Air Force pricing officials at ASD stated they believe the checks and balances for reviewing and negotiating defective pricing cases are sufficient. They said the contracting officers, pricing personnel, and attorneys from the Staff Judge Advocate review and comment on defective pricing cases. They said the negotiation of the settlement is performed by contracting officers and pricing personnel. They also stated an ASD policy, dated July 6, 1982, now provides for a contracting officer's final decision and demand for repayment where this type of action is required.

The above officials suggested the following actions could improve the process for review and negotiation.

--Set a lower limit of the amount of defective pricing which will be reported and negotiated. They believe it is not cost effective to review and negotiate insignificant amounts.

--DCAA should consider obtaining input from or visiting the procuring officer prior to commencing an audit for defective pricing. This would provide the DCAA with the details of the amount negotiated which is not normally included in the price negotiation memorandum. If the DCAA does not visit the procuring office, they should consider providing a draft of their report for comment by the procuring office prior to issuing the report. The ASD officials believe these actions would insure that the amount of defective pricing was based on the negotiated amount and not the proposed amount as happens in many cases.

It appears the observations and recommendations of the DCAA and Air Force officials are valid. However, I believe the price negotiation memorandum should be more detailed and supporting documentation organized to allow DCAA or other Government personnel to determine the amount negotiated and the basis for this amount.

OBSERVATIONS

My review of selected DCAA audit reports and results of contracting officer negotiations indicate a need for better coordination between the two parties involved in determining contractor defective pricing. My review also indicated a need for better documentaion of the amounts and rationale for the negotiated settlement. I observed instances of DCAA not being aware of the ASD negotiated amounts and rationale which resulted in differences between the DCAA report and the negotiated defective pricing. Therefore, I believe the contracting officer should be required to prepare a more detailed price negotiation memorandum and supporting documentation organized to allow DCAA or other Government personnel to determine the basis and amount negotiated. I also observed the Air Force attorneys did not document the amounts and rationale for the settled amount related to cases appealed by the contractor. It appears this documentation is needed to explain the basis for settlement just as a price negotiation memorandum is required for a defective pricing case settled by the contracting officer.

I also observed that the Air Force did not settle some defective pricing cases in a timely manner. Two cases included in my review required about 3 years 5 months and 2 years 5 months from the date of the DCAA audit report to the settlement date. The result of this delay is the contractor may have interest free use of the defective pricing amount. ASD recognized that some contractors response to their requests do not permit a timely resolution of the cases. ASD issued a policy dated July 6, 1982, which allows a demand for repayment from the contractor, where appropriate. However, it appears there is a need for some other financial disincentive to allow a more timely resolution of the defective pricing cases. The disincentive could be a charge of interest on the settled amount.

DCAA AUDIT REPORTS ON DEFECTIVE PRICING ISSUED SINCE OCTOBER 1, 1980 AND CONTRACTING OFFICER SETTLEMENT

Audit Report		Amount defective pricing	Revised report		Contract number	Status of settlement	Amount settled by contracting officer
Number	Date		Date	Amount			
3421-0A420006	12-04-80	$ 2,096,292		$ 2,096,292	F33657-76-C-0200	completed	$ 895,117
-0A420008	12-16-80	1,465,056		1,465,056	F33657-78-C-0044	completed	55,000
-0A420002	11-14-80	1,732,926	02-19-81	1,858,270	F33657-77-C-0200	completed	789,646
-1A420023	05-14-81	1,480,300	04-06-82	1,451,429	F33657-77-C-0200	completed	685,183
-1A420029	07-17-81	171,461	11-19-81	45,306	F33657-77-C-0200	completed	45,306
-1A420036	09-02-81	128,540		128,540	F33657-77-C-0200	completed	-0-
-1A420038	10-21-81	152,782		152,782	F33657-77-C-0200	completed	-0-
-2A420003	01-25-82	59,062		59,062	F33657-79-C-0079	completed	-0-
-2A420025	12-17-81	382,266		382,266	F33657-78-C-0044	completed	-0-
-7A420015	06-04-81	1,026,402		1,026,402	F33657-76-C-0100	completed	374,192
Subtotal		$ 8,695,087		$ 8,665,405			$2,844,444
-1A420005	06-03-81	$ 1,367,215	05-11-82	$ 1,556,571	F33657-79-C-0779	open	
-1A420008	07-29-81	2,009,057	12-14-82	3,340,898	F33657-80-C-0056	open	
-1A420011	10-21-81	2,836,774	01-18-83	1,109,271	N00019-79-C-0165	open	
-1A420026	03-12-81	3,178		3,178	N00140-78-C-1216	open	
-1A420025	03-12-81	4,780		4,780	N00140-79-C-0495	open	
-1A420030	05-21-82	14,414,655	01-19-83	13,013,173	F33657-79-C-0779	open	
-1A420037	11-18-81	80,788		80,788	N00019-80-C-0187	open	
-2A420022	11-04-81	377,843		377,843	N00019-78-C-0307	open	
-2A420027	05-25-82	13,344,107		13,344,107	F33657-79-C-0779	open	
Subtotal		$34,438,397		$32,830,609			
Total		$43,133,484		$41,496,014			$2,844,444

SUMMARY
FAIRCHILD REPUBLIC COMPANY
FARMINGDALE, NEW YORK
POSTAWARD DEFECTIVE PRICING SETTLEMENTS

INTRODUCTION

In accordance with the Chairman of the Senate Committee on Governmental Affairs' request we reviewed the treatment of defective pricing cases at the Fairchild Republic Company, Farmingdale, New York (FRC) under the Truth-in-Negotiations Act.

We visited the cognizant Defense Contract Audit Agency (DCAA) resident office at FRC and the Directorate of Pricing at Wright-Paterson Air Force Base, in Dayton, Ohio. Our review was primarily concerned with defective pricing postaward audits completed after October 1, 1980. We also reviewed three postaward audits completed before that date but for which settlements were made in fiscal years 1979 and 1980. On those procurements for which settlements were made, we geared our effort to determining:

--The validity of the defective pricing amounts included in DCAA's Advisory Reports on Postaward Reviews.

--The use made by the contracting officers of the advisory reports.

--The reasonableness of the negotiated settlements.

POSTAWARD ADVISORY REPORTS

From October 1, 1980 through March 31, 1983, the DCAA resident auditor at FRC had issued 14 postaward advisory reports. The reports covered procurements valued at $1.217 billion. For seven contracts valued at $27.5 million DCAA did not uncover any defective pricing.

On the remaining seven contracts valued at $1.189 billion, DCAA reported defective pricing of $11.0 million all of which is still unresolved. On two of the contracts totaling $957.4 million with $6.7 million in defective pricing, FRC and the contracting officer have not been able to reach an agreement. The result was the contracting officer issued a final decision on defective pricing accepting the entire $6.7 million as defective. FRC was also notified of its right to appeal the decision to the Armed Services Board of Contract Appeals.

Negotiated settlements

DCAA also issued three postaward advisory reports before October 1, 1980. All three were settled as follows:

Contract #	Date of report	Procurement value	DCAA defective pricing	Date of Settlement	Amount Settle
F33657-76-C-0034	6/1/80	$380,052,130	$2,193,977	9/8/81	$225,000
F33657-77-C-0027	9/4/80	4,485,936	92,895		37,483
PO00512,00176	9/28/79	17,500,000	126,430	9/30/80	11,444
Totals		$402,038,066	$2,418,302		$273,929

Contract F33657-76-C-0034 (Option 6)

Option 6 provided for the delivery of 140A-10A Close Air Support Aircraft plus related data and support equipment at a target cost of $380.0 million. The negotiated material target cost for 140 aircraft amounted to $136.4 million as follows:

		In millions
Raw Material		$ 45.2
Subcontracts		31.8
Purchased Equipment		59.4
Over 1,000,000	$28.2	
(a) Under 1,000,000	27.7	
Overhead	3.5	
Total		$136.4

FRC's original proposal of April 18, 1977 included a material target cost of $169.2 million. This amount was reduced by over $23 million to $146.0 million. About $20 million of the reduction came about as a result of a change from contractor furnished equipment to government furnished equipment for 6 items. The Air Force Negotiating Team's (AFNT) objective was to negotiate a material target cost of $123.6 million.

DCAA audited FRC's proposal which included a target price of $390.3 million and a material target cost of $146.0 million (the July 17, 1977 bill of material (BOM)). In their postaward audit of the $390.3 million proposal DCAA found what they believed to be $2,140,159 in defective pricing. The entire amount involved proposed material cost which fell in the category of items under $1,000,000 (see (a) above) as follows:

Purchased Parts	$934,029
Subcontract Items	417,682
Raw Material	154,698
Interdivisional	315,964
G&A and Profit	317,786
Total	$2,140,159

At this point, it would do well to remember four critical facts which had a significant impact on the AFNT's treatment of the $2.1 million in defective pricing.

1. DCAA's defective pricing amount was predicated on a July 18, 1977 BOM of $145.9 million while the negotiations were based on an August 18, 1977 BOM of $143.5 million. The $2.4 million reduction covered $1.2 million for negotiated decreases in procurements and $1.2 million for other factors.

2. The AFNT's negotiating posture was based on a proposed material target cost of $123.6 milion well below FRC's proposed of $143.5 million and the $141.4 million DCAA accepted.

3. The $136.4 million ultimately negotiated was below the $141.4 million DCAA accepted and the $143.5 million FRC proposed.

4. The negotiations were conducted under a different set of factsthan was used by the DCAA auditor.

Negotiated Settlement

A comparison of the positions taken by DCAA, AFNT, and FRC on the reported defective pricing amounts follows:

	DCAA	AFNT	FRC	Revised AFNT	Negotiated
Purchased equip.	$934,029	(a)$ 24,774	-0-	$22,827	$22,827
Subcontracts	417,682	(b) 76,403	-0-	60,454	60,454
Hardware	154,698	(c) 115,541	-0-	68,885	68,885
Interdivisional	315,964	(d) 269,721	-0-	-0-	39,434
Sub Total	$1,822,373	$486,439	-0-	$152,166	$191,600
G&A	105,698	28,213	-0-	11,100	11,100
Profit	212,088	56,612	-0-	22,300	22,300
Total	$2,140,159	$571,264	-0-	$185,566	$225,000

(a)-(d) See comments below.

The AFNT initially accepted $571,264 of DCAA's $2,140,159 in defective pricing as valid. The contractor denied that any amount was appropriate, and a $225,000 reduction in the target price was ultimately negotiated.

After a review of the files and the data submitted by FRC during the option 6 proposal negotiations, the AFNT further reduced its negotiation objective. The final amount negotiated represented what the AFNT believed to be an equitable settlement representing that portion of DCAA's defective pricing which was supportable.

The reasons for the AFNT changes were:

(a) The Price Analyst/Negotiator (PAN) reduced the $934,029 by $356,000 for 35 parts which DCAA considered defectively priced using the July 14, 1977 BOM prices. However the negotiations were based on an August 17, 1977 BOM which reduced the July amount by $2.4 million of which $1.2 million applied to parts negotiated during the 7/15 through 8/17 timeframe. The PAN was able to substantiate defective pricing on 11 parts amounting to $24,774. The prices for these parts were negotiated prior to July 14 and did not fall within the July 14-August 18 window and as such were valid.

Since the A-10A bill of materials included over 13,000 parts, the same analysis could not be made for all parts included in DCAA's finding. However, the AFNT were working off a proposed material target cost much below the amount accepted by DCAA in their postaward audit. Furthermore, FRC reduced the July 18 BOM by $2.4 million and the AFNT did negotiate a material target cost below the amount DCAA accepted in its postaward audit. Consequently the AFNT concluded that a $24,774 reduction should be their objective. The negotiated result reflected an additional adjustment of $1917 for offsets that were verified by DCAA.

(b) Thirty seven parts considered defectively priced by DCAA were based on the July 14 BOM. The defective pricing amount for these parts was deleted because the negotiations were based on data made available during the negotiations which reflected the lower cost. The PAN was able to sustain defective pricing on four parts amounting to $76,403. This amount was reduced in the settlement to $60,454 for DCAA verified offsets.

(c) See note (a) above, same facts apply. The BOM used in the negotiation was not the one used by DCAA in developing their defective pricing amount. The PAN did determine that three parts amounting to $115,000 were defectively priced.

The AFNT settled for $68,885 because FRC demonstrated that the price for one of the parts had been adjusted during the 8/17 negotiations.

(d) DCAA's defective pricing amount was primarily based on the fact that FRC did not disclose that one of the divisions used a subcontractor on a previous option rather than in-house production facilities even though four purchase orders had been released by the time negotiations took place. The AFNT did not sustain DCAA because:

--The four purchase orders released amounted to $75,971 an insignificant amount when compared to the contract value of over $380 million.

--The division involved did not have a formal make or buy plan but used the outside subcontractor on an as needed basis.

--The legal opinion was that it would be difficult to defend a defective pricing case in court. The AFNT position was not a strong one.

The AFNT however was able to negotiate a reduction of $39,000.

PO 00512,00176

The subject procurement provided for the acquisition of 194 shipsets of Chaff/Flare dispensers and related data (50 for option 5 and 144 for option 6). DCAA's advisory report on the postaward review of cost or pricing data for the procurement disclosed $126,430 in defective pricing--$99,810 in material cost and $26,620 in related overhead and profit. The contractor agreed to $11,444 which was the amount of reduction in the target price that was negotiated.

The alleged defective pricing centered around four major areas. These four major areas are summarized below with their approximate prices:

Part		Price
Relays	(a)	$ $8,600
Relays	(b)	58,200
Bolts	(c)	48,200
Connector & Bushing	(d)	11,400
Total		$126,400

(a) The vendor proposal was received by FRC on 31 March 1978, or 16 days after completion of negotiations with ASD. The price listed in the Bill of Material dated 8 December 1977 was a FRC procurement estimate. Therefore, defective pricing not valid for this area.

(b) The alleged defective pricing for this area concerns a discrepancy between the Bill of Material quantity and the correct quantity. The DCAA Assist Audit Report indicated what the correct quantity should be. Even though the Bill of Material included the wrong quantity, the Government was aware of the discrepancy before consummation of negotiations on 15 March 1978. Therefore, defective pricing is not valid for this area.

(c) The price listed in the Bill of Material is a procurement estimate by Fairchild. The determination of the price for the bolts was finalized on 17 March 1978, which was two days after the consummation of negotiations. Therefore, defective pricing is not valid for this area.(d) Fairchild agreed with the alleged defective pricing concerning these parts.

P060173,60174, 60181,60182

The subject purchase orders amounting to $4,485,936 covered the procurement of 16 RF4E shipsets. DCAA reported defective pricing of $92,895 consisting of $79,296 in material cost plus $13,399 in related overhead and profit. The contracting officer was able to negotiate a price adjustment of $37,482 or over 40% of the $92,895 reported by DCAA. Because of the relatively small amount involved as well as the 40% settlement, we did not pursue the matter further.

OBSERVATIONS

1. There were wide variances between the amounts reported as defective pricing by DCAA, and the amounts the contracting officers accepted as valid and settled with the contractor. The principal reason for the variances being DCAA audited and reported on facts that were different than those used by the contracting officer to negotiate contract prices. Given the data used by the contracting officer to determine the extent of defective pricing, DCAA's amounts would in all probability have been comparable to the amounts ultimately settled. Therefore, although a wide variance did exist, we believe:

- The amounts reported as defective by DCAA were valid.
- The contracting officers were using the DCAA advisory reports.
- The amounts settled by the contracting officers were reasonable.

However, these variances do point to a need for improved communications and a more coordinated effort between DCAA and the contracting officers. DCAA should consider visiting the contracting officer prior to beginning its postaward reviews and obtain relevant cost, pricing, and negotiation information. This will help lead to a more unified Government position during negotiations and help to eliminate the extensive and unnecessary efforts required to reconcile differences.

2. DCAA at FRC has issued 14 postaward advisory reports from fiscal year 1981 through March 31, 1983. Seven of the reports did not include any defective pricing, and for the seven that did no settlements have yet been made. This despite the fact that five of the reports were issued more than 2 years ago and two reports were issued more than 1 year ago.

To the extent that the contractor has been paid for the amounts ultimately settled, the contractor will have had the use of interest free Government funds for extended time periods. Such being the case there could be a reluctance on the part of the contractor to settle in a timely manner.

In order to expedite the settlement process and preclude a contractor from having the use of interest free Government funds, the contracting officer should consider including a clause in all applicable contracts to deal with the problem. The clause could provide for charging the contractor interest on the amount of defective pricing negotiated from the date of the certification through the date of reimbursement.

SUMMARY OF REVIEW OF DEFECTIVE PRICING CASES AT GRUMMAN AEROSPACE CORPORATION

INTRODUCTION

At the request of the Chairman, Committee on Governmental Affairs, United States Senate, we reviewed defective pricing cases identified by DCAA auditors at the Grumman Aerospace Corporation.

OBJECTIVE AND SCOPE

Our objective was to identify the volume of defective pricing cases and to review the reasonableness of the decisions made in settling these cases.

We obtained from DCAA a list of positive defective pricing reports issued since the start of fiscal year 1981 including their current status. We also obtained a list of positive reports issued prior to the start of fiscal year 1981 and settled after the end of fiscal year 1981.

We analyzed the settled cases and selected for further review the four cases with the largest dollar difference between the amount questioned and the amount settled on. Since one of these settlements also included four other cases in our listings, we also included them.

RESULTS

The following defective pricing cases have been identified by DCAA:

	Number of cases	Amount questioned	Amount of settlement
Issued since 10/1/80	27 (open)	$23,665,776	$ open
	9 (closed)	1,465,494	819,794
Issued prior to 10/1/80 and settled after 9/30/81	12 (closed)	4,086,305	2,218.796
	48	$29,217,575	

Of the 21 closed cases, the negotiators settled for $3,038,590 or 54.7 percent of the $5,551,799 questioned by DCAA.

In the eight cases we looked at in detail, DCAA sometimes agreed with the negotiator or revised the amount they questioned. The amounts were as follows:

Original DCAA amount	Revised DCAA amount	Amount of settlement	Difference
$ 215,323	$ 215,323	$ -0-	$ 215,323
291,480	291,480	22,146	269,334
15,662	15,662	15,160	502
243,451	243,451	234,796	8,655
147,457	147,457	-0-	147,457
105,342	105,342	-0-	105,342
724,807	423,130	180,560	242,570
727,939	228,217	-0-	228,217
$2,471,461	$1,670,062	$452,662	$1,217,400

The eight audit reports dealt with 19 items of cost which were questioned by the auditors. They were disposed of as follows:

	Number of items	Revised DCAA amount
DCAA was supported by the negotiator	7	$ 461,485
DCAA was not supported by the negotiator		
Agree with DCAA	2	118,915
Agree with negotiator	9	861,445
Other	1	228,217
TOTAL	19	$1,670,062

DCAA was supported

In the seven items where the negotiator agreed with DCAA, they settled for $8,823 less ($461,485 - $452,662) because the negotiator used the actual overhead and G & A rates, rather than the rates referenced in the post negotiation memorandum. They explained they had no guidance on what rates to use and felt that actuals represented "agreed to" rates whereas those discussed in the post negotiation memorandum had not been "agreed to" by anyone. We believe that in defective pricing they should reconstruct what would have happened at the time of negotiations if they knew of the defective data and thus they should have used the rates in the negotiation memorandum.

DCAA was not supported

DCAA was not supported by the negotiator on 12 items where they questioned $1,208,577. Our analysis of these decisions is as follows:

Agree with DCAA

The auditors questioned an item for $85,855 because an updated vendor DD633 dated August 29, 1980 was not furnished the Government negotiator. The negotiator said the proposal was received by Grumman on September 3, 1980 while they were negotiating at NAVAIR. The price was agreed to on September 5 and the certificate signed September 8, 1980. In view of the time frame, it was not considered defective. We disagree with the negotiator for the following reasons:

--The pricing certificate says it is not limited to the personal knowledge of the negotiator,

--During the same negotiations, they accepted an offset of $17,617 for another item based on something being available on September 5, 1980, and

--During the same settlement, they overruled the auditor on a $126,842 item because the information had been furnished by a September 5, 1980 letter.

The other item in question was for $33,060. Grumman included a vendor's effort at ceiling price which was accepted by the negotiator since they expected the vendor to overrun the target cost. The auditors identified a reduction of the vendor's effort which was included at target cost and therefore questioned the difference between target cost and ceiling price. Grumman's response was that the amount represented only unrecovered profit. We were unable to get a clear answer as to why the negotiator accepted this and believe that if the effort was included at ceiling price, the credit should also be at ceiling.

Agree with negotiator

Four ($414,346 questioned) of the nine items where we agree with the negotiator involve items where the auditor based his case on the premise that updated information was not furnished the Government. In each case, the negotiator cited specific letters dated prior to the pricing certificate wherein the information was furnished. We looked at three of the four items (representing $381,143) and found that the letters cited by the negotiator were also identified by reference in the pricing certificate signed by the contractor. It is clear therefore that the auditors did not do a thorough job in reviewing all the data submitted by the contractor.

The auditors furnished us a negotiation memorandum they relied on for two of these items. It is identified as a pre/post negotiation clearance and specifically says that updated data was not furnished; however, it was approved after the conclusion of negotiations. We found that it was written as a pre-negotiation memorandum but due to the delay in getting it approved, NAVMAT gave them permission not to write "post" minutes since the objective in the "pre" had been achieved. Thus there was no real post negotiation memorandum. While the auditors were not aware of this, they should have raised questions based on the date of the memorandum (after negotiations) and the language in it ("It is recommended that approval be granted to enter into negotiations").

The other five items of cost where we agree with the negotiator are as follows:

$17,993	The auditor questioned this amount because the negotiation objective of the prime contractor's buyer was not furnished. The negotiator said that the buyer's negotiation objectives do not have to be furnished.
$8,768	The auditor used a more current Cost and Price Analysis report; however, according to the negotiator he used incorrect quantities.
$105,486	The auditor's case was based on the date of a workpaper file. The negotiator accepted a more formal document with a later date.
$209,510	Grumman's proposal included the purchase of items from ROHR, including inlet ramps. Prior to the completion of negotiations, a decision was made to purchase them from another vendor. The auditor questioned the difference in price. The negotiator found there were other changes to the ROHR effort which offset the savings.
$105,342	The negotiator was unable to sustain DCAA's position in 1982 due to the age of the allegation and the nonavailability of information and backup data. The case dealt with 1971 data.

Other

The last item involved an allegation of defective pricing by a Grumman subcontractor. Originally the case totalled $528,313 at the subcontractor price level and $727,939 at the prime contractor price level. DCAA withdrew part of the amount, leaving $165,632 at the subcontractor level and $228,217 at the prime level. The negotiator agreed there was some overstatement but was of the opinion the amount was not significant in relation to the subcontractor's price of $60 million. In their opinion, if they had known about it, there would have been no change in the $662 million price negotiated with Grumman.

OBSERVATIONS

Need for more timely resolution of cases.

While we agree with the negotiator's decision to write off an old case in our sample, we are concerned with why the case became so old. We were aware of the following sequence of events.

July 22, 1975	Defective pricing report from DCAA Sikorsky to DCAA Grumman.
April 5, 1976	Defective pricing report from DCAA Grumman to the negotiator, adding Grumman loadings.
October 19, 1976	Subcontractor rebuttal.
October 24, 1978	DCAA Sikorsky evaluation of subcontractor rebuttal.
November 13, 1978	DCAA Grumman forwards DCAA Sikorsky's evaluation to the negotiator.
October 13, 1982	Negotiator closes the case.

While recent DOD directives (e.g., 7640.2) will give visibility to old audit findings, there is no assurance it will speed their resolution since the contracting officers must still negotiate with and get responses from contractors. There is no incentive for contractors to settle these cases since the longer they take, the less likely the Government will have the evidence it needs. Even if the Government eventually wins the case, the contractor has had interest free use of the money. Some type of financial disincentive is needed. One possibility would be to impose a time limit for contractors' responses. If the time frame is not met, charge the contractors interest from that date on any monies that are eventually determined to be due the Government.

Need for definition of significance

In one of our cases, the negotiator believed that $228,000 was not significant. In relation to the contract price of $662 million it can be argued it is not significant. By itself, it could be considered significant. To our knowledge, there is no definition of, or criteria for, determining significance.

Need for better coordination between auditors and negotiators

In our discussions with both parties, we detected an antagonistic rather than a team relationship. The auditors rely on the negotiation minutes and then find they weren't accurate. On the other hand, the auditors didn't thoroughly review all the documents referenced in the pricing certificate.

Some people don't believe it is possible to prepare negotiation minutes that reflect everything that occurred during negotiations. We believe that as part of a defective pricing review, the DCAA auditors should visit the contracting officers, discuss the negotiations and review the contracting officer's files to see what data he had and relied on. Several days' travel expense would be less costly than writing audit reports, having contractors respond and then not sustaining the auditors' findings because the data had been submitted to the Government.

SUMMARY OF DEFECTIVE PRICING CASES, FORT WORTH DIVISION, GENERAL DYNAMICS CORPORATION

Introducton

This summary on defective pricing cases at the Fort Worth Division of General Dynamics Corporation was prepared in response to a request from the Chairman, Senate Committee on Governmental Affairs.

Objective

To determine the age, number, and dollar value of unresolved defective pricing cases and to evaluate the settlement of three or four closed cases at the Fort Worth Division of General Dynamics Corporation, Fort Worth, Texas.

Scope

I visited the Defense Contract Audit Agency (DCAA) Resident Office at the Fort Worth Division of General Dynamics the week of March 14, 1983, to obtain information on the volume and status of defective pricing cases reported by DCAA since October 1, 1980, and defective pricing cases opened prior to October 1, 1980, but settled until after October 1, 1981. At the DCAA resident office, I asked the DCAA Resident Auditor to identify defective pricing which were settled during the last 3 years.

The week of March 21, 1983, I visited the Aeronautical Systems Division, Air Force Logistics Command, Wright-Patterson Air Force Base, Ohio, to examine files on settled defective pricing cases and to discuss these settlements with appropriate officials.

Summary Information on Defective Pricing Cases

Since January 1, 1979, the DCAA Resident Office has issued 12 reports with recommended price adjustments totaling $89.4 million at the Fort Worth Division of General Dynamics. Settlements have been reached on two cases. The combined DCAA recommended price adjustment on the settled cases totaled $4.679 million and the settlements totaled $2.359 million. Both cases that have been settled were opened prior to October 1, 1980, and were settled after October 1, 1981. Ten cases remain open at a total DCAA recommended price adjustement of $84.7 million. A list all 12 cases is included as Appendix I.

Summary of Individual Defective Pricing Cases

Case I, DCAA Audit Report No. 1361-0A-420-010, dated April 21, 1980

In April 1980, DCAA reported that General Dynamics had applied an incorrect escalation factor to calculate the proposed value of in-plant materials on contract F33657-75-C-0310, ECP0006. ECP0006 was the contractual instrument that priced the first 348 European aircraft in the F-16 program. The value of defective pricing reported by DCAA was $2,206,925 (target price).

This case was settled for $2,009,744 by a contract modification (P.O. 1275) signed by the contractor April 29, 1982, and signed by the contracting officer May 4, 1982. The difference between the DCAA amount reported and the amount of the settlement can be accounted for in the base amount used. DCAA used the proposed values of in-plant materials, while the Air Force used the negotiated values.

In an October 28, 1980, letter the contractor agreed that an error had been made. However, this case was not settled until 3 years after the contracting officer was first notified of the problem and about 2 years after the date of the DCAA report, as shown below:

1/10/79	DCAA letter to contracting officer reporting potential defective pricing
4/21/80	Date of DCAA Report
10/28/80	Contractor admits error was made
4/29/82	Contractor agrees to a decrease in contract price.

Although the contractor agreed to the error in October 1980, it submitted a proposed offset amount of $5,096,527 for an effort which the contractor stated was omitted from its ECP 0006 proposal. This offset related to support costs for the AIS (Avionics Intermediate Shop) at one the European contractors participating in the F-16 program.

In January 1981, the Air Force Plant Representative Office (AFPRO) asked DCAA to evaluate the contractor's October 1980 offset proposal. In March 1981, DCAA responded to the AFPRO by stating "In summary, [the contractor] has not been able to demonstrate there was a requirement to bid AIS support in ECP0006."

In July 1981, the contracting officer transmitted supplemental agreement no. PO 1275 to the contractor for execution. This transmittal letter stated

> "This document [the supplemental agreement] is the culmination of numerous discussions with General Dynamics personnel over the past 15 months***General Dynamics letter***28 October 1980, as well as data provided during***meetings does not support the proposed offset."

On March 25, 1982, after additional correspondence with the contractor, the contracting officer issued a final determination letter. In April 1982, the contractor signed the supplemental agreement, agreeing to a target price decrease of $2,009,744.

The dollar value settlement on this case is reasonable. However, the length of time is not reasonable. Further, it appears the contractor delayed settlement of this case by proposing offsets which the Government was never able to verify as an ECP 0006 requirement. It was 18 months after the contractor agreed that defective pricing existed before the contract value was decreased by $2 million. There were no documents in the official contract file which showed the contracting officer ever considered withholding payments to contractor because of this delay in settlement.

Case II, DCAA Audit Report No.
1361-6A-420-002, dated March 9, 1979

In March 1979, DCAA reported that General Dynamics' proposal on Contract No. F33657-72-C-0630, for F-111 aircraft, contained defective pricing totaling $2.472 million. The defective pricing related to purchase orders with three subcontractors. However, based on information obtained after the report, DCAA agreed with the Air Force to delete defective pricing on two subcontracts. Thus, the only remaining issue in this case involved a subcontract with General Electric (GE) for the attack radar system. DCAA's position was the amount of defective pricing was $1.6 million computed as the difference betweem GE's original proposal and their updated proposal.

In April 1972, GE informed GD that Warner-Robins Air Material Area (WRAMA) was contemplating an F-111 attack radar spares purchase and that if this order was placed concurrent with the GD purchase, a savings may be realized by both GD and WRAMA. The basic defective pricing issue is that GD did not make this information known to the Air Force during F-111 prime contract negotiations, which were finalized on May 26, 1972. Negotiations on the attack radar subcontract were completed 2 months after the prime contract negotiation. The amount negotiated on the subcontract was $4.850 million.

The sequence of events is summarized in the following table.

Date	Event	Amount
1/13/72	GE proposal to GD	$6,503,957
4/19/72	GD proposal to USAF	5,802,499
	Air Force Objective for GE subcontract amount negotiation (In prime contract negotiation)	5,268,198
5/26/72	Prime contract negotiated	-
7/24/72	GE revised proposal to GD	5,180,782
7/25/72	GE subcontract negotiated	4,850,000

Although $1.6 million in defective pricing remained as the Air Force official position in correspondence with GD until at least March 1981, about August 1980, the Air Force in-house objective was about $700,000, which was computed as follows:

Air Force Position on Defective Pricing
RE: GE/GD Attack Radar (about August 1980)

Air Force Objective (In prime negotiations for GE purchase order)	$5,268,198
Negotiation Increase (based on total bottom line prime settlement, 2.4%)	126,437
	5,394,635
Less: Actual amount of GE-GD purchase order (negotiated after the prime contract)	4,850,000
	544,635
Other factors	14,106
	530,529
Plus overheads	109,077
Target cost	639,606
Target profit	56,285
Target price	$ 695,891

On February 6, 1981, the contracting officer notified the contractor that his final decision in this case was for a price reduction of $1,602,475. On March 3, 1981, GD appealed the contracting officer's final decision with the ASBCA.

After the contractor's appeal, an Air Force trial attorney became actively involved in settling of this case. Air Force and contractor officials met August 26, 1981, in an attempt to negotiate a settlement. According to notes in the Air Force price analyst's file, the Air Force offered $1.224 million in target cost and the contractor offered $100,000 in target price. The Air Force negotiators next offered $696,500 (target price) and the contractor responded with a $200,000 offer. The Air Force officials rejected the contractor's offer and decided not to continue the negotiation at that time.

On December 8, 1981, the Air Force trial attorney and the contractor agreed to a settlement of $350,000 (target price) and the contract was modified to reflect this decrease in price in early April 1982. According to the trial attorney, it was clear that defective pricing existed; however, it was difficult to assign a precise dollar value to the defective pricing. Since the case was based on non-disclosed data, it would require speculation to determine what effect such data would have had on the negotiated price. Because of the possibility of rejection by the ASBCA, which would mean zero dollars recovered by the Government, the trial attorney concluded that a $350,000 settlement was reasonable.

It was over three years from the date of the DCAA report to the date of the contract target price adjustment. File documents show that procurement officials were not satisfied with the length of time it took for the contractor to respond to the DCAA report and at one point in time, consideration was given to withholding progress payment to gain the contractor's cooperation. However, this action was not taken by the Administrative Contracting Officer. If payment had been withheld, it is likely this case would have been settled sooner.

A judgement on the amount of the settlement is difficult to assess. However, what is clear is that because of recent ASBCA rulings that tend to favor contractors, Government attorneys are reluctant to present cases before the ASBCA due to concerns about adverse rulings and this encourages negotiated settlements, especially when there may be some basis for questioning evidence supporting the Government's position.

Case III, DCAA Audit Report
No. 1361-0A-420-011, dated
April 21, 1980

Unlike cases I and II, this case has not been settled. Consequently, it was not discussed with procurement officials. This case has generated a great deal of controversy between DCAA and Air Force contracting officials and has been open for 3 years.

On this procurement, General Dynamics is a subcontractor to Singer-Link, the prime contractor for the F-16 Training Flight Simulator, under prime contract number F33657-77-C-0565. The subcontract is identified as 2S59997.

In January 1978, the subcontract was negotiated without an audit of the subcontractor proposal. In October 1978, DCAA/Fort Worth refused to audit the proposal because the subcontract had already been negotiated. However, DCAA did perform a post award review and issued a report on April 21, 1980, which questioned $1,418,934 relating to engineering labor hours. The DCAA report stated that actual cost history of engineering labor hours under previous tasks of a similar nature were much lower than the judgemental estimate, manloading of engineering hours, included in the subcontract proposal.

In November 1980, the contracting officer notified DCAA at Singer that defective pricing did not exist because the subcontactor had fully disclosed that manloading was used in the proposal and the Government by stating that defective pricing existed, would be dictating contractor pricing methodology.

In a December 1980, DCAA/Fort Worth submitted a memo to its region, expressing disagreement with the contracting officer's disposition of defective pricing, in accordance with DCAA procedure, CAM 12-705. The DCAA region supported DCAA/Fort Worth's position, stating that the contracting officer's rationale "*** is totally counter to the public law" and forewarded the DCAA/Fort Worth package to DCAA Headquarters. DCAA Headquarters, in a January 27, 1981, memo also supported the DCAA/Fort Worth position and advised the DCAA region to seek resolution of this problem with the contracting officer's superiors.

In February 1981, DCAA met with Air Force procurement officials. A February 9, 1981, DCAA/Fort Worth memo to the file concerning this meeting stated that the procurement officials reversed their previous position and agreed that defective pricing did exist. Then in a March 3, 1981, letter to DCAA/Fort Worth, procurement officials once again reversed their position. They argued that Singer's best and final offer to the Government included a $2,203,174 decrease from the subcontractor's proposal of $12,136,336, which more than offset the $1.4 million in defective pricing and that the Air Force planned no further actions on this matter. In May 1981, DCAA/Fort Worth notified the Judge Advocate General's office (at AFSC) that in DCAA's opinion the Air Force is not considering the natural and probable consequence theory set out in DAR 3-807(10).

In an April 1982 letter to Singer, procurement officials stated that the DCAA finding has merit but as of February 1983, the case was still open. In a February 24, 1983, memo to procurement officials, DCAA/Fort Worth again contended that defective pricing exists on this subcontract.

This case appears to demonstrate an example of what some Government officials believe is a problem in the settlement of defective pricing cases. This problem relates to Government procurement officials not aggressively pursuing settlement of defective pricing cases. The reason for this lack of aggressiveness may be two fold. First, defective pricing may give the appearance that the officials who negotiated the procurement may not have performed their job properly, even though this may not be the reason for defective pricing. Frequently the person who negotiated the contract is also charged with settlement of the defective pricing case so there is a built-in conflict. A second reason for the lack of agressiveness may be that the Government official may have frequent contact with contractor officials over several years, especially in the procurement of a major weapons system. Thus, when the Government official aggressively pursues defective pricing, the working relationship with contractor official may become strained.

Because of real or suspected conflicts between other duties and settlement of defective pricing, some Government officials are of the opinion that the settlement of defective pricing cases should be removed from those who negotiate, or administer the contracts or use the end item under contract, and be given to an independent group at the DOD level for settlement. Based on the length of time some cases remain unsettled, this could well be a workable solution to the problem. Further, such a group could be given authority to direct contracting officiers to withhold contractor payments when the contractor is unresponsive or uncooperative.

Overall Observations and Recommendations

Based on the three cases described above and discussions with Government officials having several years of experience with defective pricing, it is my impression that every phase of settlement of these cases favors the contractor and the Government needs to protect its interests by improving its administration in this area.

One major improvement would be a requirement that contracting officers impose financial sanctions on the contractor if a case is not settled within 6 months or so. These sanctions could be in the form of withheld progress payments or perhaps charging interest on the amount of funds disputed. Until contractors have a financial incentive to settle defective pricing cases, settlement will remain a low priority. Under the present system, contractors rather than the Government benefit from a case remaining open. Not only does the contractor have free use of the money, but the older a case becomes the more difficult it is for the Government to win the case in court. This is true because witnesses may die, retire, or transfer and records may become lost or misplaced.

Another area that seems to benefit contractors is the practice of allowing contractor to propose offsets (See Case I). This can be used as a device to delay settlements under the present system. Further, unless the offset relates specifically to the defective pricing issue itself, it seems incongruent with the Public Law (87-653) to allow offset proposals since the contractor has certified that his proposal was current, complete and accurate. In my opinion, offsets should only be permitted if the contractor error or omission is directly related to the Government defective pricing finding, or, if the Government, in some way, caused the error to be made.

Another possible improvement in administration might result if the Government officials involved in the negotiation, administration, or use of contractors' products were completely removed from the role of defective price settlement. This could be accomplished by establishing a high level DOD entity with authority to negotiate defective pricing settlements. This would remove those with a vested interest in the success of a weapon system program from the settlement process.

APPENDIX I

GENERAL DYNAMICS/FT. WORTH DEFECTIVE PRICING REPORTS ISSUED SINCE 1-1-79 and CURRENT STATUS

AR# 1361 -	Date of Report	Contract/Action	Recommended Price Adj. (000)	Disposition/ Status Ref.
6A-420-002	3/09/79	F33657-72-C-0630 (F-111 Program)	$ 2,472	* 1
0A-420-011	4/21/80	P.O.2S-59997 Under Singer-Link Prime Contract No. F33657-77-C-0565	1,419	2
0A-420-010	4/21/80	F33657-75-C-0310, ECP0006 (F-16)	2,207	* 3
0A-420-013	4/21/80	AF33(657)-13403 & AF33(657)-8260 (F-111) Norden Subcontracts	5,217	4
0A-420-110	6/24/81	F33657-75-C-0310, Basic Program, FSD, (ECP0001 to FSD (F-16)	52,820	5
-FY 82-				
2A-420-102	11/09/81	FPRA RS91N,F33657-78-C-0669 (F-16) & Other Potential	7,230	6
1A-420-105	3/03/82	F33657-75-C-0310,ECP-0114 (F-16AME)	2,619	7
2A-420-105	6/29/82	F33657-75-C-0310,ECP's 0019R1, R1C1, R1C2 (F-16)	1,009	7
2A-420-106	8/02/82	F33657-75-C-0310, ECP 0036R2 (F-16)	1,510	7
-FY 83-				
3A-420-101	1/03/83	F33657-78-C-0669 FY 1980 Buy (F-16)	6,174	8
3A-420-102	2/10/83	F33657-78-C-0669 FY 1981 Buy (F-16)	5,063	8
3A-420-108	3/02/83	F33657-78-C-0669 & F33657-75-C-0310 ECP 425 (F-16)	1,683	7
			$89,423	

* Settled - See Reference Notes

Ref

1. This action covered 3 subcontractors (General Electric P.O. #489, Autonetics P.O. #481, and Texas Instruments P.O. #423). Based on additional data provided subsequent to report, DCAA agreed to deletion of amounts applicable to Autonetics and Texas Instruments from the report, leaving a revised defective pricing amount of $1,602,475 applicable to General Electric. In June 1982, DCAA was advised by GD that the case had been settled in December 1981 for $350,000.

2. General Dynamics is a subcontractor to Singer-Link on this case. It has not been settled. DCAA responded to General Dynamics/Singer's rebuttal of July 6, 1982 on February 24, 1983. The auditor involved was working on the Multi-year F-16 proposal from May 1982 - January 1983 and therefore the DCAA review of the contractor rebuttal package was delayed.

3. This case involved erroneous calculations for escalation used by GD in proposing and negotiation of ECP 0006. The case was ultimately settled for $2,009,744 in May 1982.

4. A meeting is scheduled at GD/FW for 3/21 - 3/22/83 between DCAA (Norden), AFPRO, and GD to try to resolve this case.

5. On March 29, 1982, DCAA received from WPAFB the GD Response dated in February 1982 to this audit report. The contractors response totalled 179 pages and because of involvement in the Multi-Year proposal key DCAA personnel were unavailable to review and evaluate the lengthy rebuttal. By telecom and by letter dated 1 June 1982 DCAA so notified the Air Force. Review of the response is now in process.

6. This case involves data included in local rates that were disclosed and reported by the Corporate DCAA auditors at St. Louis. This was discussed at the GD CAC Conference in Fort Worth the first part of November 1982; however DCAA has received no response from Procurement or GD/FW regarding the report.

7. No response from procurement or GD/FWD regarding these reports.

8. No formal responses from procurement or GD/FW regarding these reports; however, DCAA did receive a phone call requesting that copies of the reports be provided to GD/FWD and the local AFPRO. The phone call (2/2/83) concerned the FY 80 buy; but DCAA understands the contractor is also reviewing the FY 1981 Buy report.

APPENDIX A

OPEN DEFECTIVE PRICING CASES AS OF MARCH 14, 1983

Contractor	Number of Open Cases	DCAA Position (in millions)
General Dynamics	10	$84.7
Grumman Aerospace	27	23.7
Fairchild Republic	7	11.0
McDonnell Douglas	9	32.8
TOTALS	53	$152.2

CLOSED DEFECTIVE PRICING CASES REVIEWED IN THIS EVALUATION

Contractor	Number of Cases Settled	DCAA Position	Amount of Settlement
General Dynamics	2	$3,809,400	$2,359,744
Grumman Aerospace	8	1,670,062	452,662
Fairchild Republic	3	2,418,302	273,929
McDonnell Douglas	5	7,397,786	1,425,234
TOTALS	18	$15,295,550	$4,511,569

Chairman ROTH. At this time we will call forward the first panel, Mr. Harvey J. Gordon, the Assistant Deputy Under Secretary for Acquisition, Mr. Charles O. Starrett, Jr., Director, Defense Contract Audit Agency, Mr. Derek J. Vander Schaaf, Acting Deputy Inspector General.

If you will please come forward. Gentlemen, I will ask that each of you limit your presentation to 10 minutes. I will ask the committee staff to maintain time so that we can warn you. Your full statement, however, will be included in the record as if read.

At this time I would ask Mr. Gordon to please proceed.

TESTIMONY OF HARVEY J. GORDON, ASSISTANT DEPUTY UNDER SECRETARY FOR ACQUISITION, DEPARTMENT OF DEFENSE; CHARLES O. STARRETT, JR., DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY; AND DEREK J. VANDER SCHAAF, ACTING DEPUTY INSPECTOR GENERAL, OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE.

Mr. GORDON. Good morning, Mr. Chairman, and members of the subcommittee.

I am pleased to have this opportunity to appear before you today to present my views on Public Law 87-763, commonly referred to as the "Truth-in-Negotiations" Act. I have a detailed statement for the record which I would like to summarize for you at this point.

The act provides that prime contractors and subcontractors shall be required to submit cost or pricing data and to certify that data submitted are accurate, complete and current prior to the award of negotiated contracts, contract modifications and subcontracts expected to exceed $100,000—this threshold was increased to $500,000 by Public Law 97-86 on December 1, 1981—unless the price negotiated is based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, prices set by law or regulation or, in exceptional cases, where the head of the agency determines that the requirement may be waived and states in writing the reasons for such determination.

Any prime contract, change or modification thereto under which such certification is required shall contain a provision that the price to the Government, including profit or fee, shall be adjusted to exclude any significant sums by which it may be determined by the head of the agency that such price was increased because the contractor or any subcontractor required to furnish such a certificate, furnished cost or pricing data which, as of a date agreed upon between the parties which data shall be as close to the date of agreement on the negotiated price as practicable, was inaccurate, incomplete, or noncurrent.

The law also provides for a downward price adjustment if the cost or pricing data is subsequently found to be defective. DOD proposed legislation to increase the threshold from $100,000 to $500,000 in part to account for the impact of inflation and to reduce the amount of paperwork.

The increased threshold, however, has not diminished the value of the act because the total dollar value of DOD procurement subject to the act has been reduced by a relatively insignificant amount in comparison to the significant decrease in administrative effort and paperwork for both Government and industry. In that regard, I would like to point out that in 1981 there were 28,121 actions under $500,000 of which small business was 6,802. By increasing the threshold there are now only 773 small business actions out of a total of some 7500 that were previously impacted by the act.

Yet in the previous year DCAA reported no audits for defective pricing data for procurements under $500,000. In fiscal year 1982 there were 23,794 actions under $500,000 of which 8,000 were small business. There now remain, because we are limiting our activity to procurement over $500,000, only 948 out of almost 7,000 small business actions impacted by the act and 7,458 are large business actions.

So what we are suggesting is that our action eliminated a substantial administrative burden primarily for the small businessman in an area where we were not doing many audits in any event, and while we have eliminated some 70-plus percent of the workload we have still retained coverage of 92 percent of the costs. We think that is cost effective from our perspective.

DOD implementation of the act: We accomplished it in four major segments, the preproposal effort, the proposal evaluation process, the contract negotiation phase, and the postaward phase. I will address each of these areas briefly.

Prior to requesting a price proposal from a contractor, the contracting officer prepares a document entitled "Request for Proposals." Detailed instructions for the preparation of this document are included under DAR section 3 part 5. These instructions provide guidance to insure that any subsequent contract complies with all applicable laws and regulations. After receipt of the contractor's proposal, the contracting officer initiates the proposal evaluation process. The basic policy of the Department of Defense is to procure supplies and services from responsive and responsible sources at fair and reasonable prices calculated to result in the lowest overall cost to the Government.

Prior to negotiation of a contract or modification resulting from a proposal in excess of $500,000 when price is based on cost or pricing data submitted by the contractor the contracting officer shall request an advisory field pricing report. The field pricing report will include both a DCAA audit of the cost and financial aspects, and an engineering evaluation report covering the quantitative factors in the proposal such as the need for quantities and mix of labor or hours, et cetera.

If the proposal is less than $500,000, the contracting officer has the option of requesting—but need not mandatorially request—field pricing report or he may perform the analysis himself. Under either scenario, the contracting officer is ultimately responsible to insure that a proper analysis of the proposal has been accomplished.

The negotiation phase of the procurement cycle includes establishing the price objective obtaining management approval of the price objective, resolving differences over substantial questioned or unresolved costs in the audit report, conducting the negotiation conference, reaching agreement on price, obtaining the certificate of current pricing data and preparing a record of the negotiation.

In the interest of time I will spare you the details of how this is managed except to suggest to you that our regulations require the negotiator to carefully document the negotiation process, report on the outcome of that process to the auditor, reconcile differences with higher level management within his contracting office to the extent he differs with the auditor, document the degree to which he has or has not relied upon data provided by the contractor and to obtain a certificate of current pricing data from the contractor.

In the postaward phase, if it is found that cost or pricing data is not accurate, complete and current as stipulated by the certificate of current cost of pricing data, we do the following: If inaccurate, incomplete or noncurrent and by reliance upon it the Government was prejudiced, the Government is entitled to an adjustment in the negotiated price, including profit or fee, to exclude any significant sum by which the price was increased because of the Government's reliance in negotiations on defective data.

When the contracting officer concludes that defective pricing exists, a contract price adjustment in the amount by which the defective data caused an increase is requested from the contractor. If this is not accepted by the contractor and the contractor furnishes additional information that may not have been available to the contracting officer in reaching his position, the contracting officer will attempt to negotiate a fair and equitable settlement of the contract.

As in the case with many types of disagreements between two parties, the underlying facts are not always clearly to the advantage of either party. If the parities are unable to reach a mutually satisfactory settlement, the contracting officer will issue a final determination or decision from which the contractor may appeal to the Armed Services Board of Contract Appeals. Or he may file a suit as provided for by the Contract's Dispute Act of 1978 in the Court of Claims.

Issuance of a final decision with the possibility of subsequent litigation is something that is not done without careful analysis and legal counsel and it is subject to higher review, with all of those who have technical input to offer.

Once the defective pricing case is settled DAR 3-812 requires the contracting officer to prepare a memo on the audit report indicating how the issue was resolved. A copy of that memo is forwarded to the auditor issuing the audit report and to the cognizant administrative contracting officer. One might conclude that the issue of defective pricing is relatively simple, but on the contrary it is a very complex subject. It requires a complete analysis of all the facts of a given situation and the exercise of careful judgment after consideration of the facts. To summarize, we believe that the purpose of Public Law 87-653 to be twofold. First and foremost, to provide contracting offices with the same cost or pricing data that is available to the contractor thereby increasing the assurance that fair and reasonable prices are negotiated at the outset.

Second, in the event that defective cost or pricing data is determined to be in place, it entitles the Government to an equitable adjustment. We are constantly on the alert to ways in which to improve our policies and procedures to insure that the resulting savings are experienced by the Government. I would like one final opportunity to comment on one last point.

In fiscal year 1982, the Department of Defense negotiated contracts valued at about $39 billion that were subject to Public Law 87-653. Also of interest is the fact that there are overaged defective pricing audits in some phase of settlement totaling about $210 million. While we readily agree that is a substantial sum, it is as a percentage of what we have negotiated one-half of 1 percent of the total. When you consider that we recover some portion of that, 60 percent, which is the estimate that we have from DCAA, it further reduces that percentage. Even though this is relatively insignificant when viewed as a part of the total, we are not complacent in our efforts to improve and we expect to do better and resolve most of the open defective pricing cases during this fiscal year. Thank you, Senator.

Chairman **Roth**. Mr. Starrett, will you please make your summary?

Mr. **Starrett**. Good morning, Mr. Chairman. My name is Charles Starrett, Director of the Defense Contract Audit Agency. I have submitted a statement for the record and with your permission, I will briefly summarize it..

The Defense Contract Audit Agencies guidance on defective pricing is premised on the belief that it is more advantageous to the procurement community and the taxpayers as a whole to correct estimating deficiencies causing defective pricing before they occur rather than to rely solely on trying to find them later by performing compliance reviews. The deterrence of contract overpricing is accomplished through the performance of estimating systems surveys and preaward reviews. Estimating system surveys are comprehensive reviews of contractors organizations, policies, procedures and practices used to prepare cost estimates for price proposals. These surveys are intended to ascertain the general level of reliability of contractor estimates, to identify areas of weakness that may require special emphasis during the review and negotiation of individual pricing proposals, and to recommend improvements necessary to effect corrective actions.

A second way in which the Defense Contract Audit Agency [DCAA] attempts to identify deficient estimating procedures causing defective pricing occurs as an integral part of the agencies program to review and evaluate pricing proposals submitted by contractors. This second preventive way probably results in avoiding defective pricing more than any other means. The third part of our program to combat defective pricing concerns the performance of Public Law 87-653 postaward compliance reviews. From its inception the Agency's defective pricing compliance program has been accorded a high priority, second only to the review and evaluation of the demand type assignments. The principal area of observation of our defective pricing compliance reviews are to ascertain whether individual contractors are in compliance with Public Law 87-653 as it relates to specific pricing actions; two, to recommend contract price adjustments necessary for Government recovery of contract overpricing caused by defective pricing; and, three, to recommend actions to correct the deficient contract or estimating procedures.

We believe that the DCAA defective pricing compliance program successfully accomplishes the intent of Public Law 87-653 as interpreted by the Armed Services Board of Contract Appeals and the Court of Claims.

This opinion is based on the fact that 28 separate reviews performed by the General Accounting Office and other internal audit organizations have not disclosed any significant weaknesses in our program. I want to assure you that I intend to maintain effective audit coverage of this important area and we would be pleased to assist the committee in any way that we can as various aspects of Public Law 87-653 are considered.

I want to express my appreciation for the opportunity to appear before the committee today and I will try to answer any questions.

Chairman ROTH. Mr. Vander Schaaf?

Mr. VANDER SCHAAF. Thank you, Mr. Chairman. I am very happy to be here.

I want to take this opportunity to thank you for the help and the very positive role you played in establishing the Inspector General in the Department of Defense. I hope we can fulfill the mission you expect of us in the years to come.

I am here today to speak about the defective pricing in Department of Defense contracts. The Inspector General's Office believes that effective pricing reviews are an important tool in maintaining accuracy and honesty in the negotiation and administration of Government contracts. Unfortunately we have a rather poor history of resolving defective pricing reviews in a timely manner.

The Defense Contract Audit Agency spends about 3 percent of its time on defective pricing reviews. They currently represent about 23 percent of overaged reports over 6 months old and about 16 percent of the dollar value of overaged reports.

We are also unsure with respect to what the percentage of sustention of cost questioned is. I am sure there will be more testimony about that this morning.

We favor renewed emphasis on performing high quality reviews, resolving them in a timely manner and increasing the sustention rate of the costs questioned.

The Department of Defense recently issued Directive 7640.2, "Policy for Followup on Contract Audit Reports." Actually it is a revision of an earlier regulation. The directive deals with the problems of contract audit followup and resolution. It was very difficult to get this directive approved within the Department of Defense. Some of the statements you will hear in today's hearing and in future hearings on this matter will address how this directive is going to resolve and solve many of the problems that we have in the Department. However, there exists a large element inside and outside of the Department that did not want the directive. My full statement deals with that a little more.

The Directive requires that DOD components track and report certain post-award contract audit reports from the receipt of the audit to final disposition. All defective pricing audits are covered by the directive. Disagreements between contracting officers and auditors must be reviewed by boards of review or senior acquisition officials if the contracting officers and auditors cannot resolve them.

With respect to audit policy, our office is in the process of setting up an audit policy and oversight organization. We are hiring some new people. A few of the projects we have underway are the implementation of Directive 7640.2, and review of reviewing defective pricing audits with over $1 million in questioned costs. We have completed a series of reviews of subcontractor pricing proposals. I want to talk about those subcontractor pricing proposals and what we found a little later on.

We are also reviewing settlements of defective pricing cases in which the adjustment is not made to the original contract, but is made instead to a current contract. We are also reviewing the methods used in determining how many and which defective pricing reviews are performed by the Department's auditors.

Why are defective pricing cases so hard to settle? First of all, as you have said this morning Mr. Chairman, the contractor has very little reason to settle these audits at the present time. Second, I believe that contracting officers tend to view defective pricing audits as a negative reflection on their performance. They have many other priorities. They are more interested in working new contracts and current projects and may not have the time to work defective pricing cases that they would like to have.

Another point is that the defective pricing audits often involve old rather then current funds. The benefit from getting the return on those funds will not necessarily be to the program office that is working the defective pricing audit. It will be to the Treasury as a whole.

Another consideration is the policy of setoffs. The law as currently interpreted reduces the recovery percentage by allowing the contractor to seek setoffs in other cost areas. This prolongs the negotiation process and difficult to reach a settlement. Key employees change jobs and facts become more obscure.

Finally defective pricing audits often involve complex issues. Finally, settlements are dependent on the facts of each individual case. Neither the auditor nor the contracting officer has all the facts at his fingertips. Obtaining the facts can be a difficult problem.

Why do we in the Inspector General's Office believe DOD should put more effort into defective pricing reviews? First, we recently conducted some reviews of the use of cost or pricing data in subcontractor proposals. We looked at three programs: The Black Hawk Helicopter program, the LVT 7A1, which is the Marine Amphibian Assault Vehicle and the F100 engine. In each of those cases, my reviewers felt that the Government contracting officer had less than sufficient knowlege with respect to the situation involving the subcontractors proposals.

Second, I believe there are some direct and hidden benefits from conducting more defective pricing audits. The direct benefit is that we receive something like a 20-to-1 return on each dollar invested in defective pricing audits. That amount is not as large as the return on various type of forward pricing audits, where we are receiving as much as $130 for each dollar of audit effort invested. Of course, those two numbers are not totally compatible because a large portion of the latter amount would be realized even if the auditors were not there. Price analysts, administrative contracting officers and other individuals on the contracting officers team also help to produce those savings. However, the contract auditor certainly plays a very important role in the process.

A less obvious payback from defective pricing audits is that they help to insure that the certification of cost or pricing data is in fact credible. If you do not reform defective pricing audits, the contractor has no incentive to submit accurarate cost or pricing data in the first place. So you have to spend at least a portion of your time doing defective pricing reviews.

I also believe that if we put more emphasis on defective pricing audits, we can reduce the variance between the costs questioned and the actual amount sustained. I believe Mr. Kinlin is going to testify in these hearings and he will have a lot more to say about some aspects of this problem.

If you were to change Public Law 87-653, the Truth-in-Negotiations Act, what would the Inspector General recommend? First, we believe that the threshold for certification of cost or pricing data should revert back to $100,000, not the newly established $500,000 level. The certificate itself does not add a paperwork burden on the contractor. It is a single piece of paper. It does put some pressure on contract to make sure that their cost or pricing data are accurate.

Restoring the $100,000 threshold will help to increase coverage where it is most needed. Many of the smaller contracts go to smaller firms. Some of these firms do not have the experience in Government contracting that many of the larger prime contractors have. They do not have approved estimating of accounting systems. They do not have sophisticated cost schedule and control systems that our auditors update at regular times and check for authenticity. So I think it would help to look at some of those smaller contracts and be sure that the Government is getting what it pays for.

When the contract auditors are reviewing another contract or contractor proposal and they find some indication that defective pricing may exist they can easily transfer that knowledge to other contracts valued at less than $100,000 that the contractor holds with the Government. In this way, we have an opportunity to recover some of those costs under smaller contractors if defective pricing has occurred.

I recommend that you consider requiring contractors to pay interest on defective pricing amounts determined to be due the Government. If you do decide to establish such a requirement you then have to decide when the interest should start to accrue. I think the committee should consider whether to start the clock running at the date of the contract negotiation, the date of the first progress payment or somewhere in between. I believe that interest should start to accrue from the date of the first progress payment but only to the extent that the contractor had use of Federal money based on defective pricing.

I also believe that if you put an interest charge into effect, you will help to clean up the backlog of open cases. That will give the contractors an incentive to clean them up.

Contractors are now paid very high rates of progress payments. These rates have increased significantly in recent years because of the high cost of money. My auditors recently examined a major contract in which we are paying 98 percent progress payments. The contractor has certain costs which it approves, but does not actually pay prior to its Government billing. The contractor bills the Government for those costs. I am not saying that it happens in all contracts, but it happens in some contracts from time to time. Adding an interest provision to the law would help to rectify the situation and help us to get rid of the old open contracts.

I would like to make one other recommendation. That is to reduce the threshold for review of pricing proposals. Field pricing review is a DAR requirement. It is not a statutory requirement. I recommend that you reduce the requirement back down to the $100,000 level for firm-fixed-priced contracts and $250,000 for fixed-price incentive and cost type contracts. I believe that the Defense Contract Audit Agency agrees with my position on that matter.

That is all I have, Mr. Chairman.

Chairman ROTH. Thank you, Mr. Vander Schaaf.

We will follow the early bird order. The first Senators to come will be the first to question. On the first round, I will limit it to 10 minutes.

Mr. Gordon, would you say it is in the interest of the U.S. Treasury to spend a dollar if it saves the U.S. Treasury $20?

Mr. GORDON. The answer to that question is yes. However, I would like to add in answering that question, some additional information——

Chairman ROTH. I will ask each of you to keep your answers as brief as possible, please.

Mr. GORDON. By raising the thresholds to $500,000, we achieved a 65 percent reduction in the paperwork and still maintained visibility over 93.4 percent of the costs.

Chairman ROTH. Mr. Gordon, I want to get into that in a minute. But let me point out that the record shows that a full year before you made this change both the Defense Contract Audit Agency and the Defense Inspector General informed you that audits of price proposals under $500,000 were resulting in cost savings to the Government of $170 million a year at a cost to the Government of only $8 million in audit resources. In other words, a return of $20 for each dollar spent.

I don't think the figures you are now mentioning of 60 percent, I will get into that in a moment, is really relevant to my question.

I regret that Dr. DeLauer couldn't be here today and I do want to go on record that we do expect and we have given enough advanced notice to the Defense Department of these hearings and we do expect the people with primary responsibility for these programs to be here. That is not to say we are not appreciative of having you here, Mr. Gordon.

Is it not correct, Mr. Starrett, that you recommended prior to this new ruling that the $100,000 threshold be retained?

Mr. STARRETT. During the time that the DAR Council was considering this question we did provide statistics to the Council which indicated the savings that you are talking about. However, we were concerned with varying thresholds. We were looking for approximately $100,000 for firm fixed price contracts, $250,000 for flexibly priced contracts and $500,000 or even possibly a million dollars for cost type contracts. The basis for this recommendation was the return on the investment in each one of these areas.

Chairman ROTH. You would agree, however, that a $20 return on $1 spent is a pretty good return?

Mr. STARRETT. Yes, sir, that is about the same return we get in the defective pricing area when we are doing the post award reviews.

Chairman ROTH. Mr. Vander Schaaf, would you care to comment?

Mr. VANDER SCHAAF. The Inspector General's Office wrote to Dr. DeLauer on January 4, 1982, and recommended essentially the same position that Mr. Starrett has just told the committee about. I don't believe there is any real difference between our position.

Chairman ROTH. You would recommend that we restore that?

Mr. VANDER SCHAAF. Yes, sir.

Mr. GORDON. I want to distinguish between the audit for defective pricing data and the audit of a contractor's pricing proposal. For audit of pricing proposal, the DCAA experience has been $132 return for every dollar invested. We in DOD would rather see them focus their attention so we can get $132 back for every dollar we spend rather than $20 to $1 and in the area where the preponderance of our dollars are really going.

So from our point of view, we would rather see resources devoted in an area where most of our dollars are and where we can get a return six to seven times as great. In terms of audit for defective pricing data, DCAA conducted no audits for defective pricing data below $500,000. So to get the certificate at that threshold, and then have no audits, did not seem to us to be an effective way to proceed.

Chairman ROTH. It seems to me the point that Mr. Vander Schaaf made in his testimony is that the requirement of a certification is not a great burden in and of itself. I would like to go to the semiannual reports on audit inspections and operations issued by the Department of Defense. Two reports covering fiscal year 1982 showed that DCAA completed over 1,300 defective pricing reviews indicating defective contract prices of over $200 million.

The two reports also show that in fiscal year 1982 contracting officers obtained refunds from contractors for only $28 million. These statistics indicate that the government settles defective pricing cases with contractors for only a small percentage of the original findings reported by the DCAA.

Mr. Gordon, why is that? Is that because of defective work in reporting by DCAA? Is it lack of aggressive action on the part of the contracting officer? What is the reason for this difference?

Mr. GORDON. I would like to defer to Mr. Starrett on that question except I do want to note that our statistics indicate over 60 percent.

Chairman ROTH. Let's go to that.

Mr. STARRETT. There does seem to be some confusion on these numbers. If I can, I think I can explain them. The first number reflects all of the recommendations made during the year to contracting officers. The second number is the dollar amount resolved, made of two relating elements. It doesn't really compare with the first number.

The first number is——

Chairman ROTH. What are you making reference to?

Mr. STARRETT. The reports that you referred to. Could I show a chart? I would like to present some numbers.

Chairman ROTH. All right.

Mr. STARRETT. This seems to be a question that comes up.

The sustention rate in defective pricing was 54 percent in 1980, 66 percent in 1981, 46 percent in 1982, and 74 percent for the first half of 1983. The numbers that you have to use to get to these are the dollar value of the amount of price adjustments recommended during the year that were settled versus the amount that the contracting officer got from those recommended price adjustments. These numbers have shown the acquisition people in the last 2 years at least that we want to attend negotiations, we want to go to negotiations regardless of whether it is in the forward pricing area or the incurred cost area.

The idea of getting into these negotiations is to increase these percentages of sustention. The more you increase those percentages the more dollars we will get back in each one of categories of work that we do. Eventually we will have work in three areas, forward pricing, defective pricing, and incurred cost.

By increasing the sustention rate and the forward pricing area by 1 percent, we would save another $122 million with the help of the contracting officers.

Chairman ROTH. I would like to ask Mr. Vander Schaaf if you agree with those figures?

Mr. VANDER SCHAAF. I haven't had a chance to examine those figures, Mr. Chairman. I can only report on the figures provided by DCAA for inclusion in the semiannual report. Those figures, as Mr. Starrett said, are somewhat like comparing apples and oranges in one respect. Some of the sustained defective pricing statistics relate to audits that were completed years ago. This is because it takes so long to negotiate them. By the time we get the decision on the audit, we are showing cost sustained in the current year that do not relate to the amount that we show on the other side of the column, or this year's questioned costs.

It is like comparing obligations and expenditures. Obligations tend to lead expenditures over a period of time, and the expenditures will catch up all things being equal. They should appear to be equal over time. There are several sets of figures circulating around this problem. I have a chart of figures here that my people developed from information provided by DCAA which would indicate the high recovery rate of 1 year was 1973 at 47.6 percent, a low rate here back in 1969 at 4.5 percent. Over the entire period the negotiated amount is roughly in the 20 percent range, looking at these figures.

Chairman Roth. I think the third chart, the color chart, reflects the figures that you are referring to.

Mr. VANDER SCHAAF. I believe that is correct. Yes, sir.

[The chart referred to follows:]

DEFECTIVE PRICING CONTRACT PRICE ADJUSTMENTS RECOMMENDED BY THE DEFENSE CONTRACT AUDIT AGENCY AND NEGOTIATED BY CONTRACTING OFFICERS FOR THE YEARS 1966 THROUGH 1982

Year	Contract price adjustments (millions of dollars)		Percent of amount recommended by DCAA negotiated by contracting officer
	Recommended by DCAA	Negotiated by contracting officers	
1966 & 1967	$13.0	$3.9	30.0
1968	17.0	2.7	15.9
1969	85.1	3.8	4.5
1970	70.7	4.0	5.7
1971	65.2	8.8	13.5
1972	85.9	14.9	17.3
1973	41.2	19.6	47.6
1974	(1)	(1)	
1975	52.2	15.7	30.1
1976	25.4	14.3	56.3
1977	27.8	3.9	14.0
1978	26.4	9.5	36.0
1979	71.1	21.2	29.8
1980	73.5	12.6	17.1
1981	197.3	44.1	22.4
1982	216.9	22.8	10.5
Total	1,068.7	201.8	18.9
Less unresolved Sept. 30, 1982	207.7		
Net	861.0	201.8	23.4

[1] Unknown.

Chairman Roth. In other words, what you are saying is that if you go back to 1966, 1967, the percent of amount recommended by DCAA that is negotiated by the contracting officer varies very substantially down through the years. As you say, the low point of recovery was in 1969 and 1970. I think that was 4.5 and 5.7. Is that correct?

Mr. Vander Schaaf. Yes.

Chairman Roth. The high point, maximum recovery was 1973, at 47.6 percent. But if you go down the years, if you take the accumulation of figures, starting with 1967 and go through 1982, the contract audit adjustments recommended by DCAA totaled over $1 billion and if you eliminate the $201.8 million that have not been resolved you still on an average get only a return of 18.9.

So that you are not getting this 60 percent rate of return that is being claimed. I think that is what is raising questions in people's mind.

Mr. Vander Schaaf. It raises a question in my mind.

Chairman Roth. I see the gentleman behind you shaking his head. But this is the Inspector General.

Mr. Gordon. I would comment that IG's are not incapable of not being perfect. What I am suggesting is—

Chairman Roth. Let me complete my statement. I would just point out that these figures are based on reports, aren't they, issued?

Mr. Vander Schaaf. The total figures are not. The IG reports——

Chairman Roth. That is a summary. That is right.

Mr. **Vander Schaaf**. We have only included this type of data on the comparative basis for the last 18 months, or two IG reports. When we look at the two IG reports—and this is again comparing apples and oranges to a certain extent—we have reported a return rate of 14 percent.

Chairman **Roth**. Would you repeat that, please?

Mr. **Vander Schaaf**. The return rate that we have reported has been in the 14 to 15 percent area given the caveats I just stated.

Chairman **Roth**. I think my time is up.

Mr. **Gordon**. Those figures reflect the following. When an auditor questions a cost, he goes to the negotiator, that negotiator settles, we then look at what he settled for against the cost questioned. Our statistics reflect those percentages as a function of the cost in the final settlement that was sustained by the negotiator vis-a-vis the costs that were questioned by the auditor.

We think that is the meaningful comparison to find out how well the auditor is or is not being supported in his findings. I would appreciate if Mr. Starrett could comment on which of those two in his opinion is a more correct reflection of what is happening.

Chairman **Roth**. Senator Rudman?

Senator **Rudman**. Thank you, Mr. Chairman.

I have only one question. It is fairly broad and I would like all three witnesses to answer it. Because as we talk about all of these statistics and you know somewhere amongst all of the numbers there is certainly a lesson. I believe the lesson is that we could be doing more.

I am talking particularly now about what we all know goes on in the defense procurement systems, the so-called buy-ins at lower prices which causes defective pricing. It is intentional defective pricing.

There have been numerous GAO reports on this matter and only an idiot looking at the status of acquisition or the selective acquisition during the course of the last 2 years would to conclude that major contractors have not been buying in.

In many cases, major contractors buying in on major systems, when the service estimate costs were a lot more realistic. Yet the buy-in price was approved for all sorts of reasons.

One of those reasons being that if Congress knew what the actual cost was going to be in the beginning, we probably wouldn't appropriate the funds. But be that as it may, you enter into these various buy-in situations of which there are many.

You have your audit. We find precisely what is wrong. We look at the cost growth which last year was enormous. This year better.

What do you do after you find the defective pricing in terms of penalizing the offending contractors? In some cases the offending contractors have been doing this for years over and over and over again on a whole variety of contracts.

What kind of input does Mr. Starrett's organization have, Mr. Gordon, into the procurement decisions that are going to be made by the Defense Department in the case of contractors that have a history of buying in and then being guilty of, defective pricing or if you wish, creative marketing but the fact of the matter is that they continue to get these contracts?

Would you please answer that for me?

Mr. GORDON. Well, sir, the defective pricing issue isn't really directly related in the sense that the government's recourse under defective pricing is to get a downward adjustment where the contractor has exaggerated or increased the price improperly because of defective data.

Your question addresses the issue of whether the contractor knowingly, willfully, or through inadvertence understates the price. In that instance, we formulate what is known as an independent estimate of the most probable cost of contract performance.

We, under the existing law, cannot refuse to award to a contractor because he has priced the contract effort lower than we think it should fairly or reasonably cost.

We do not have the right to unilaterally adjust upward contract prices to what we think they should be. In fact, there have been GAO decisions to this effect.

What we try to do in our formal source selection procedures is not to consider the prices that have been proposed but rather what we think is the most probable estimated cost to complete in evaluating one contractor relative to the others.

With respect to all major systems acquisitions, all such proposals from every contractor, even the unsuccessful one, are supported by a detailed advisory audit which includes both the DCAA input, the ACO input, and the DCAS technical representative.

In that respect, I would like Mr. Starrett to comment as to how they contribute in that process.

Mr. STARRETT. In Mr. Gordon's opening statement, he walked through the process from the request for proposal to the proposal. After the proposal is received, then we get into the act by performing an audit.

If the contractor has proposed a price we believe is lower than the price that we think it will ultimately end up costing for whatever it is that is being procured, we will say so in the audit report.

When you apply Public Law 87-653 to that type of situation, there is a little bit of problem in that the law only provides for downward adjustment of price. So if you found there was data that was defective that would result in the price increasing, you could not increase the price under Public Law 87-653.

Senator RUDMAN. Of course the issue I am discussing is the issue where in fact you have a negotiated price. You are aware of these systems probably as much as I am.

There are legions of them. The services feel that the price is probably defective in some way but as you say, under the law they accept it.

Now, as you come down into the 2, 3, 4, and 5 year, there is enormous cost growth and I contend there is cost growth because there was not enough effort in the first place to disqualify that individual.

Maybe they know how to price too well.

Mr. GORDON. You are quite correct. Under the acquisition improvement program iniatives, great attention is now being given to realistic budget estimating, realistic estimates for inflation and cost realism.

We are in the process of revising the DOD directive on source selection and proposal evaluation which would mandate that increased emphasis be given to contractor past performance, particularly in the area of controlling costs.

The emphasis is on realism of his proposal in terms of the estimated costs to perform. We are doing everything that we can within the law to attempt to discourage buy-ins. A great deal of buying, I must however note, occurs not because of willful underestimation, but technical optimism and the failure to budget for failure rather than just for success.

Senator RUDMAN. Of course a lot of it is technical optimism but nevertheless there are a number of instances in which the service estimates were considerably higher than those of the contractor. I would contend that one of the reasons this has happened is because the service estimates did not came up to us here on the Defense Appropriations Committee, where I also serve or the Armed Services Committee, which Senator Cohen serves on and Senator Levin, and Senator Bingaman. If they had, I believe, we would have probably said wait a minute, we don't want to buy anti-tank weapons because they only cost $79 to $1,200.

Well, you know it is partly inflation. You know the one I am talking about. I am simply saying to you that I am glad you have got this new initiative.

I would like to see some evidence in the coming year that contractors who have a repeated history of cost growth for other than technical reasons, are not rewarded with contracts without very close scrutiny.

Thank you, Mr. Chairman.

Chairman ROTH. Thank you, Senator Rudman.

Senator Bingaman?

Senator BINGAMAN. Thank you, Mr. Chairman.

I am just interested in trying to run down a few questions that occurred to me from Mr. Vander Schaaf's testimony, if I could.

On page 9 you have a list of contract status reports for some of the contractors where I gather there has been substantial delay in getting these resolved.

I am having difficulty from the testimony written telling how some of these amounts questioned are.

You say they have been open for at least 6 months.

Mr. VANDER SCHAAF. Yes. I have some backup material of when some of these audits took place, Senator.

You have to understand that some of these are in litigation before the Armed Services Board of Contract Appeals or Court of Claims and for that reason alone they are going to be extended for a long period of time.

Under those circumstances, they require some time. That is not the reason all reports are overaged however. I believe the number of litigations is 11 out of 145.

Senator BINGAMAN. 11 of the 145 in litigation? You don't have ready information as to how old some of these are?

Mr. VANDER SCHAAF. They go back as far as 1974.

Senator BINGAMAN. 1974?

Mr. VANDER SCHAAF. However, we greatly reduced the amount of old defective pricing reports during the past 2 years. The new directive, 7640.2 as I said in my testimony puts some pressure on the contracting officers to settle these cases. I think Mr. Gordon would agree to that.

Senator BINGAMAN. How much of the $200 million or so that you have there would be over 5 years old in your opinion?

Mr. VANDER SCHAAF. About $60 million or 30 percent are over 2 years old.

Senator BINGAMAN. Thirty percent would be over 2 years old?

Looking at your testimony, you list several contractors and the number of reports. There is a marked difference between the number of reports there for a few and the number of reports for most. For example, you have Grumman Aerospace with 32 reports out of the total of 145. What would be your explanation for that kind of a lion's share of the outstanding reports on this particular exhibit?

Mr. VANDER SCHAAF. I am not sure there is an explanation that I can give you. Our reporting system in the Department does not come forth with the reasons why each of these cases may be open. I would have to assume that Grumman decides to contest a larger number of these defective pricing audits than other contractors.

Senator BINGAMAN. Let me ask you about the recommendation which I understand you were making in your testimony, that an interest charge be imposed on the amounts that are determined to have been overcharged over a period of time.

What kind of a proposal are you making? Do you have any specifics?

Mr. VANDER SCHAAF. I was suggesting that the committee consider using the Treasury rate. The Treasury Department establishes a rate for these purposes. The question then becomes of when one should attempt to apply such a rate in order to get timely resolution. I don't believe it should be applied at the time when the contracting officer makes a decision that defective pricing took place. That may be after 3 or 4 years of progress payments on the contract or even longer. I believe it should be made some time following the completion of negotiations on the contract and/or around the time that the first defective progress payments are made on the contract.

Senator BINGAMAN. I am just wondering, what is the IRS charging now for delay in paying taxes that are due this Friday?

Mr. VANDER SCHAAF. That is an excellent example. I don't know what they are charging. When the IRS catches you 4 years in arrears in taxes, they don't start charging you interest at the point they caught you. They start to charge you interest at the point you failed to file the return or made the error. That is essentially what I am suggesting in my testimony.

Senator BINGAMAN. I am advised it is 16-percent interest for taxpayers. Does that seem like a reasonable charge for the companies involved here?

Mr. VANDER SCHAAF. That is probably a little high because the IRS charge also includes a penalty.

Senator BINGAMAN. You think 16 is OK for us but not these companies? [Laughter.]

Mr. VANDER SCHAAF. I suggest charging interest only. I am not prepared to recommend charging a penalty as used by the IRS.

Senator BINGAMAN. All I know is that my accountant told me that I should go ahead and pay my taxes by this Friday in order to avoid paying that 16 percent.

Let me ask you: You also refer to criminal investigations but I can't tell from your testimony the extent to which this has been done. Can you give me some specific information?

Mr. VANDER SCHAAF. I will try to give you some statistics. Of course I can't discuss the specific firms involved. Generally the firms have been smaller companies. We have had 16 cases that have gone all the way through the judicial system since the history of this bill. Currently, there are four cases in various stages of investigation or prosecution.

Senator BINGAMAN. There are now pending just four cases which are either being investigated or are in some kind of judicial proceeding. You don't know for how many of those a decision has been made to prosecute?

Mr. VANDER SCHAAF. Only one case has gone to prosecution and it resulted in a conviction.

Senator BINGAMAN. I guess it would be fair to say that the threat of criminal prosecution is not a major factor in any of these problems?

Mr. VANDER SCHAAF. I would have to agree with that. But it is probably not a major factor because it is difficult to prove intent under the False Claims Act. In most cases there is no intent to defraud. I don't think our investigators usually find an intent to defraud. We are dealing with complex cost accounting matters that are subject to various interpretations. Therefore, it is very difficult to prove intent in these situations.

Senator BINGAMAN. Let me just ask one other question which is not directly related. I saw a program on 20/20 3 or 4 weeks ago where they were making various allegations about overcharges on spare parts I believe. I think the company was Pratt & Whitney. I am not sure. But there were some fairly striking increases, 1,500 percent increase in price in 1 year in particular parts.

Is that something that is the subject of one of these investigative audits? What is the status of that? Do any of the witnesses know what is being done with regard to that?

Mr. STARRETT. I believe I can answer that, Mr. Bingaman. We do have those contracts in our defective pricing program for review. We are going to review the spare parts contracts that were involved in that for defective pricing purposes.

Senator BINGAMAN. When would you expect to have some kind of resolution or when would you be able to report back to this committee, for example, as to your conclusion about the validity of those allegations on that program?

Mr. STARRETT. If you are talking about subsequent to the negotiation by the contracting officer, I couldn't give you an estimate, but as far as the DCAA audit report we probably will have that out within the next 2 or 3 months.

Senator BINGAMAN. I would be anxious to see that when you get it. I think that program got sufficient attention that I think it is incumbent upon us to try to resolve whether or not in fact those kinds of increases did take place.

If so, what the justification was and if the justification is not there, what is being done about it.

Thank you, Mr. Chairman.

Chairman ROTH. Thank you.

Senator Cohen?

Senator COHEN. Thank you, Mr. Chairman.

Mr. Gordon, how much money is recovered through these defective pricing reviews and enforcement proceedings?

Could you provide an annual figure?

Mr. GORDON. Yes, Senator.

Senator COHEN. Just a rough ballpark figure.

Mr. GORDON. I have the information.

During the period of 6 months ending September 30, 1982, we closed 38 overaged contract audit reports which represented 19 percent of the total of those that were overaged and the dollars involved were $80,804,000.

That is a total of $80,804,000 out of total audits of $265 million in outstanding costs that were questioned.

Senator COHEN. Let me just use the rough figure of about $80 million.

I don't want to suggest that the size of that figure, $80 million, is not a lot of money. I would, however, like to put it in the context of what Senator Rudman was discussing.

OPENING STATEMENT OF SENATOR COHEN

Senator COHEN. It is not only the contractor who buys into our defense procurement system. DOD historically has bought into the system by underestimating the projected inflation rate for the coming year. So when everybody else knew the inflation rate was going to be 14 percent, nonetheless the projection coming out of OMB was 7 percent. So that was the way DOD was buying in.

Just so we don't get too pious up here on the podium, we in Congress, buy too. Everybody on this particular podium today, everybody in this Congress, works to protect a contractor once he or she has gained a contract. We buy into the system because we want to see that those jobs are continued. We fight like hell to make sure they don't close down a plant in our respective States.

So everybody is buying into the system. It has been my own belief that we are never going to break this cycle unless it is broken first over at DOD. By the time it comes to us, by the time the contracts are let, by the time the negotiation is completed, it is virtually impossible for anybody in this Congress to have the time or interest to start canceling out contracts which affect their own States.

So if we are ever going to break the cycle, it has to be broken over at DOD. You have an obligation to see to it that, No. 1 the program is needed, and No. 2, we were buying it at a reasonable price.

Let me come back to what Senator Rudman was saying. Even though we feel that when there is a deliberate under estimating historically demonstrated by certain contractors, there are some that I could name, there is a remedy, called debarment and suspension.

Does that fall within your responsibility, Mr. Vander Schaaf?

Mr. VANDER SCHAAF. Yes, it does.

Senator COHEN. Isn't that an area we can examine?

Mr. Vander Schaaf. We don't usually debar or suspend for that kind of problem. We tend to use this penalty following prosecution on fraud.

Senator COHEN. We may have to amend that law. I am trying to get at the problem we are talking about here. I don't know what your budget is and I don't know what you spent to collect that $80 million in defective pricing last year, but in relation to the amount of money lost on cost growth in major weapons systems, it is de minimis.

I don't want to say it is peanuts. That demeans the figure of $80 million. However, I can tell you about one weapons system that has over $200 million overrun right now due to "mismanagement."

That is one system. We have had example time after time where we have seen tremendous cost growth. In one quarter at the end of fiscal year 1981, for example, there was cost growth of some $47.6 billion on our major weapons systems.

That is where the money is really being wasted, not the $80 million in defecting pricing which we are spending a good deal of time to go back and try to recoup.

Whatever the weapons system might be, whether it is an M-1 tank or anything else, there is a good probability that the cost of the system will start out low and grow to enormous amounts of money. That is where I think the focus of our attention has to be. Again, this is not to minimize the importance of what we are doing here, but it does not compare to the other.

Mr. VANDER SCHAAF. If I might add, the Department has some initiatives underway to get onto this front end cost problem early.

Mr. Gordon indicated some of those to you. I think they are somewhat effective. How effective are they going to be over the long run. We still have to wait for the answer.

Senator COHEN. Senator Rudman just reminded me. $17 up to $1,400. As you multiply that times the number of weapons systems you want to purchase, it is quite a few millions, isn't it? That is the kind of example we are talking about. We are looking at the top down, asking, have you overestimated your cost? I think the bigger problem is that the contractor literally underestimates the cost, maybe not intentionally, but because of technical optimism.

I think the contractor ought to eat his technical optimism. When they say they can complete a contract for a certain price and find out later that they cannot, they turn to the Government to pay the difference.

If the contractor is that optimistic, why don't you hold him to that price?

Does anybody have an answer to that?

Mr. GORDON. Are you suggesting we use firm-fixed price contracts for R&D?

Senator COHEN. I think it is a possibility. I am not recommending it. I happen to represent a contractor that does pretty well. I won't get into bragging, as I do from time to time, but this contractor has had a reputation for adhering to certain contracts, even coming in under budget.

I want to know, why can't other contractors be held to the same kind of standard? When they go over budget, why should they be able to turn to the Government and say, sorry, we made a mistake. It is mismanagement. We really didn't know how to produce this system. The Federal taxpayer has to pick up the difference.

Mr. GORDON. I don't really disagree with anything that you said. You will find that the acquisition improvement steering group will complete its second year report sometime on or about the end of this month, and it will reflect some new initiatives being adopted by Secretary Thayer.

You will find, first and foremost, six or seven areas for which there is going to be intensified management: Improve program stability; enhanced competition, as a way of providing for more realistic estimating and more realistic cost; the question of cost growth.

We feel that a lack of program stability and the inability to make vertical cuts rather than stretching things out is one of the principal reasons that we have cost growth, in addition to unrealistic estimating, unrealistic factors for inflation.

This is a subject which requires special treatment. It will be afforded special treatment.

I think you will be pleased to note that the Department of Defense is not being indifferent to this problem. We recognize it.

Senator COHEN. I take it from your statement that you think the Defense Department ought to have more competition in contracting?

Mr. GORDON. Yes.

Senator COHEN. I would assume you would lend your support to the bill that Senator Levin and I have authored, supported by Senator Rudman, Chairman Roth and others, to pass legislation which is going to require more competition in contracting in both the defense and civilian agencies?

Mr. GORDON. I think the Department of Defense's position on that bill is that while it has some difficulties with some technical aspects of it, the thrust of the legislation is one with which we agree.

The preference in Government should be for competition as opposed to sole source, rather than the preference of advertised procurement as opposed to negotiated procurement.

Senator COHEN. Would support the concept of making it more difficult to contract noncompetitively and promoting more competition?

Mr. GORDON. We have already taken internal action to insure there was increased attention to more effective competition within the DOD. That is part of the acquisition improvement program.

We now have advocates for competition in each of the procuring activities. The services have been assigned goals and milestones to achieve more effective competition.

We have also done several studies to see how we can enhance competition, simplify contract format, and have more effective competition at the subcontract level.

So you are not alone in these efforts. Whether or not we agree with each and every one of the things in the bill is yet to be coordinated within the Department.

Senator COHEN. Let me finish one final question.

One of the problems we have had, even though there have been past statements favoring competition in contracting, is that the majority of the contracts are awarded on a sole-source basis.

I would hope that with your strong support for more competition in contracting, that you would find it in your heart and within the DOD management to come before the Armed Services Committee, which is going to be holding hearings in the next week or two, and lend support in the areas we are undertaking. I hope we share the same goal.

Let the record indicated that he nodded. [Laughter.]

Chairman ROTH. Senator Levin?

Senator LEVIN. Mr. Chairman, I have a very brief opening statement that I would like to read and perhaps you could just hold off the clock for 1½ minutes while I read this.

Chairman ROTH. Please proceed.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Mr. Chairman, the statutory authority of the Department of Defense to negotiate contracts as opposed to formally advertising those contracts and soliciting bids dates back to 1947. During the 1950's there was a great deal of concern over the level of contractor profits that could be earned by inflated cost estimates in noncompetitive contracts.

A series of efforts culminated with the Truth-in-Negotiations Act in 1962, often referred to as the "defective pricing" law. For more than 20 years now this law has allowed the Government to negotiate contracts in the way of basic business common sense. The law simply requires that when contracts are awarded without competition then the contractor should submit his cost and pricing data to the Government and certify that his data is correct to the best of his knowledge.

Two years ago with the DOD authorization bill for fiscal year 1982, the Congress raised the threshold at which this cost and pricing data would be certified from $100,000 to $500,000. This was done at the request of DOD. After 2 years it has become clear that this threshold should not have been raised and for that reason I offered an amendment to return that threshold to the $100,000 level on S. 338, the competition and procurement bill. This bill and amendments were approved by the full committee with the support of the chairman and other members of the committee last month.

The first three witnesses today all had an important role to play in this threshold debate. I am glad that we have them here together. In fact, the Defense Contract Audit Agency represented here today argued that in fiscal year 1981 over $176 million was saved by DCAA reviews of the contract of the $100,000 to $500,000 range. According to that same memo this savings when compared to audit costs showed a return on these costs of $20 in savings for every $1 in audit costs.

I want to go to that $20 to $1 comparison. Mr. Gordon, I think tried to deflect that question, stating when we do the pre-award audit we collect $20 back for every $1 invested, but the post-award contract audits return $132 for every $1 invested, if I remember your figure.

Wouldn't you rather—that was your word—wouldn't you rather get $132 back for each $1 invested than $20 back for each $1 invested? My answer is yes to your question. Now our question. Would you rather get back $20 for each $1 invested than to not make the investment?

Mr. GORDON. Of course.

Senator LEVIN. Why don't we make the investment?

Mr. GORDON. The statement, more correctly, that I made, sir, is when we conduct forward pricing audits we find on those audits of contracts under $500,000 we usually get on the average about $20 return for each $1 invested. For procurements over $500,000 the return of our investment is about $132 for every $1 invested.

Given the fact that many of the dollars under $500,000 would be saved irrespective of whether or not we had a certificate, because we do have other techniques for determining reasonableness of price, we would like to focus our manpower resources on the larger procurements because we get a much greater return.

Senator LEVIN. That makes sense. What doesn't make sense is why we don't use manpower resources to focus on the $100,000 to the $500,000 since the return is plenty good.

Mr. GORDON. I would like Mr. Starrett to comment on what resources he does or does not devote to it.

Senator LEVIN. He supports this. You are the one who opposes it. I don't think the symbolism here is lost on anybody. We have got the Inspector General of the Defense Department, and the DCAA recommending we go back to the $100,000 threshold, but we've got the Defense Department opposing it.

Mr. GORDON. We don't oppose having audits below $500,000. We just don't feel it should be made mandatory. We feel it should be left to the discretion of the contracting officer to request audit assistance when and where he thinks it is appropriate and necessary to assist him in determining the reasonableness of the price.

Senator LEVIN. You oppose——

Mr. GORDON. He is not precluded from doing it. We find most of the people who are relieved of the paperwork are small businesses.

Senator LEVIN. Let's take a look at the paper load. Do I understand that the pricing data is still required or are we wrong on that?

Mr. GORDON. Pricing data is not required to be submitted on the DD-633 form for procurements that are negotiated under $500,000.

Senator LEVIN. So we don't require the data. Would you say that—the reporter can't hear your head nod.

Mr. GORDON. I am saying under $500,000, in negotiated procurements, the contracting officer is not required to request cost and pricing data from the contractor in the format that is usually attendant with a full audit.

Senator LEVIN. When you used to require the certificate, did we also require the data?

Mr. GORDON. Yes. When you get the certificate you must have data to which he is certifying. You can get the data, however, though even though you don't require the certification.

Senator LEVIN. Was there a time when you were requiring the data without the certificate?

Mr. GORDON. Yes.

Senator LEVIN. You have changed that? Is that right, by regulation?

Mr. GORDON. In 1962, Public Law 87-653 changed that.

Senator LEVIN. So what we changed is the requirement of the certificate but we didn't change the requirement relative to the data. That is done by internal DOD action?

Mr. GORDON. That is correct.

Senator LEVIN. When did you then withdraw the requirement for submitting the data?

Mr. GORDON. In 1981 DAR was changed so that the contracting officer has the same judgment that he could exercise between $100,000 and $500,000 which theretofore had been reserved to only below $100,000.

Senator LEVIN. Are you saying that if we provide the manpower to do the $100,000 to $500,000 audit you don't object to it?

Mr. GORDON. If the manpower is provided there would be no objection with the understanding though that we are trying to increase competition and we are trying to increase our industrial base. To the extent that we make dealing with the Government more onerous, particularly for small companies, we are going to be inhibiting that effort. It is very difficult for a company even though it may not require more paperwork to certify, to agree to be subject to all kinds of consequences for a system that doesn't report—within his own company—costs and estimates to the same standard or degree that the Government would expect under the defective pricing.

Senator LEVIN. What are the horrendous requirements? We get back about $1 out of every $6 that we identify. What is so horrendous about paying the money to the Government that you owe to the Government under the contract without interest?

Mr. GORDON. I think, if I may, that analogy is strained.

Senator LEVIN. It is not an analogy. It is a question.

Mr. GORDON. When you owe Uncle Sam taxes, and you don't pay it, you owe it from the day you file your income tax return. When you submit defective pricing, you don't get paid by the Government the day the contract is awarded. You may not get paid by the Government until 5 years later when the item is delivered. If in the intervening time it has been discovered that you made a mistake and the Government adjusts the contract price downward, it isn't taking back from you money that it has paid you. It is just reducing the contract price before you have been paid.

Senator LEVIN. I think that is a good point. But in some cases we are getting back money that we paid, do we not?

Mr. GORDON. Usually we are getting back an adjustment downward with the contract price. In overage contracts which have been completed and closed out, are we actually receiving the check but not in the majority of cases.

Senator LEVIN. I understand. But there are many contracts where we are getting money back?

Mr. GORDON. I would have to defer to Mr. Starrett.

Senator LEVIN. What percentage of the cases do we get money back as contrasted to not making a final payment?

Mr. STARRETT. I really don't have that information, I really don't know.

Senator **Levin**. Mr. Gordon, do I understand that the Defense Department position is you do not object if we mandate the $100,000 reviews again provided we give the manpower to DCAA to do it?

Mr. **Gordon**. I can't really speak for the Department because I don't know what the coordinated position would be within the Department. My own personal views are other than the adverse effect it might have on encouraging business to do business with the Government, I would have no objection.

Senator **Levin**. We also have that adverse effect for contracts of $600,000, don't we, or $700,000?

Mr. **Gordon**. What we are saying is that we don't think we gave up very much by increasing the thresholds. We got a lot of efficiency in return for it.

Senator **Levin**. A lot of efficiency internally?

Mr. **Gordon**. We think we may have given up about $30 million a year in terms of potential cost recovery. We feel out of the $170 million, we would have seen about $140 million of that in any event and yet we have reduced about 75 percent of the paperwork.

Senator **Levin**. DCAA agrees with those figures? The $140 million, $170 million, the net loss of only $30 million figure?

Mr. **Starrett**. I believe the numbers over here on the right, in the last chart are correct as far as this area is concerned.

Senator **Levin**. Do you agree with the figures Mr. Gordon just gave us? I would like you to answer that question. Do you agree with the figures that Mr. Gordon just gave us that we would only lose about $30 million?

Mr. **Starrett**. I don't have any way of really figuring that out. The numbers that we are talking about are the results of audits that have been accomplished. The amount of effort that a small business contractor might save in the administrative work depends upon whether the negotiator puts him through the tenth degree at the negotiation table. The contractors might have to go back and again build the same proposal that they had to build before in order to justify the price.

Senator **Cohen**. My information is that the contracts over $100,000 that are roughly involved include about 65,000 actions which would cover about $73.8 billion. Contracts over $500,000 involve a reduction of that 65,000 figure to roughly 13,000 actions and $68 billion. So you are talking about a $5 billion difference which would not be covered.

Mr. **Gordon**. Those are pricing proposals, not defective audits.

Senator **Cohen**. That nontheless is a $5 billion difference between the amounts of money.

Mr. **Gordon**. What we are saying is that those are the amounts of dollars that won't be covered by forward pricing proposals. That doesn't necessarily mean that because you don't have an audit of a forward pricing proposal that there would be no reductions in the contractor's price proposal.

Senator **Levin**. You have stated today, Mr. Vander Schaaf that returning the threshold to $100,000 for contract certification adds no administrative effort to the DOD and very little effort to the conractor?

Mr. **Vander Schaaf**. Yes. I think this paperwork argument has been grossly overstated. The facts are that the contracting officer whether he is dealing with $100,000 to $500,000 or above $500,000, is not going to negotiate a contract without cost or pricing data of some kind. To say because you no longer have to make a certification that the contracting officer is no longer going to get cost or pricing data just doesn't follow, in my mind. The contracting officer still has to develop cost or pricing data. At the last point in the process there may be some reduction in work and effort because the contractor does not have to certify the data or currency of those prices. Presently if the negotiation is going on for a long time, 6 months, 1 year or so, the contractor would have to submit new data in order to render the certification and there may be some extra work at the end.

Senator **Levin**. My time is up, Mr. Chairman.

I would request Mr. Gordon to provide for the record explanation of the $140 million, $170 million, net gain of only $30 million, how he arrived at that figure.

Mr. **Gordon**. All right, sir.

[The information follows:]

Your pre-hearing Question No. 4.d. identified savings by DCAA audits of proposals under $500,000, to be $170 million annually. Our evaluation of the process, to be followed by contracting officers in negotiating contracts of less than $500,000, indicated that we could negotiate reductions of at least $140,000 million annually without the mandatory requirement for an advosory field pricing report. Therefore, we would be placing at risk a maximum of $30 million. To achieve these results, contracting officers will still obtain audits and other other field reviews in those cases where they believe it is necessary. In addition, they will utilize approved forward pricing rates for labor and overhead in determining the reasonableness of the proposed costs. In further support of this position, I would like to refer to a portion of the testimony here today, by the Acting Deputy Inspector General of the Department of Defense, wherein he stated a large portion of savings from pre-award audits would in fact take place whether or not auditors were there because of the efforts of price analysts and other members of the contracting officer's team who help to reduce those prices.

Senator **Levin**. Thank you.

Chairman **Roth**. Mr. Vander Schaaf, we estimate that approximately $500,000,000 a year could be saved if the defective pricing law was effectively implemented. Would you agree with that, that that much more money could possibly be saved?

Mr. **Vander Schaaf**. I do not think I have any data to base a hard number on. I wish I could. It certainly is in millions of dollars. But I just do not know a good figure to use.

Chairman **Roth**. Do you think we can save much more than we currently are if the law is effectively implemented?

Mr. **Vander Schaaf**. Yes, sir. I note the use of the word effectively implemented. I do not know precisely what changes to existing law you have in mind that could further increase recoveries.

Chairman **Roth**. I understand that the Defense Contract Audit Agency now is using roughly 3 percent of its resources for the defective pricing reviews. Do you think this is adequate?

Mr. **Vander** Schaaf. No. I believe we ought to move to a little higher plateau, at least intitially, maybe in the 5 to 7 percent area. This is partly the result of our evaluation of subcontractors proposals in the past. We have reason to believe there are a lot of contracts underway where the cost or pricing data may not be adequate. It may make sense to go back and check those contracts. Once we get that situation settled, then it might be advisable to go back down to the 2 to 3 percent level again. But for now, we would recommend some increase in the numbers of defective pricing audits.

Chairman ROTH. Part of the problem, I understand to be the fact that at least some contracting officers look upon this kind of an audit as a review of their own efficiency or own effectiveness, that if they go back and raise questions they are in a sense they are involved in self criticism. Is this a significant problem?

Mr. VANDER SCHAAF. I do not believe it is a significant problem. But there certainly is that flavor to a defective pricing audit.

Chairman ROTH. Mr. Starrett, in conducting their investigation in preparation for this hearing, some of my people were advised by you that no information would be provided to the committee that would jeopardize DCAA's relationship to the procurement community. Is that correct?

Mr. STARRETT. No, sir.

Chairman ROTH. You never made any statement along that line?

Mr. STARRETT. No, sir. As a matter of fact, this discussion concerning the $100,000 Treasury hold, I think it is exactly in contradiction of that.

Chairman ROTH. You would not in any way refuse information because it would, and I will quote again, "jeopardize DCAA's relationship to the procurement community?"

Mr. STARRETT. No, sir. I think that has just been demonstrated. We are an independent organization in the Department of Defense. We call them the way we see them. I think the record clearly states that we are——

Chairman ROTH. I just want to say that that was at least the impression you gave to some of my staff and I want to underscore that, that it is not your responsibility to maintain a relationship with the procurement community. As the auditor, independence is a keynote. As a matter of fact, I am not really that happy with the resolution that we made in the DOD Inspector General Act with respect to your organization last year. I personally felt DCAA should report to the Inspector General and am considering pushing that idea again. But I just want to make very clear that we expect to receive from you whatever information is necessary in the orderly processing and investigating work of this committee.

Senator Cohen?

Senator COHEN. Just for my own edification, what is the procurement community?

Mr. STARRETT. I believe that that term includes the people that work in the acquisition side of the Department of Defense, that do the buying, administer the contracts and such things as that.

Senator COHEN. In what way could you possibly jeopardize the relations with that community?

Mr. STARRETT. One of the things, I am not agreeing that this is a problem, but one of the things that we have been very concerned about, one of the reasons that we did not want to be a part of the Inspector General organization is that we have to attend the negotiations. These negotiations are run by contracting officers on the acquisition side of the house. We have found that if we go to these negotiations we can speak to our findings, we can talk about what it is that we think is wrong with a proposal, what problems this contractor has and we do not have to go through a second party, or have somebody else do the talking for us. This has an additional effect on the Defense Contract Audit Agency in that it has a controlling effect on auditors. It limits the number of hip-shooting type things that we might do, not that that is a problem. But nevertheless, if you are going to stand up in front of a contractor representative and you are going to try to sell something that does not have any support you will soon learn that that is not the way to go. You will do your homework, you will be a much better auditor. So there are many things that are related to attending these negotiations that I think are important. Again, these statistics I think, over the last few years, indicate that it is resulting in a higher sustention rate of our findings. We do not believe that we would be welcomed in negotiation, if we were part of an Inspector General organization.

Chairman ROTH. If I might interrupt there, I would point out that during those discussions, there was going to be a split, an allocation of DCAA personnel between those who were doing pre-audit work and those who were doing postaudits. It was only those involved in the post audit field that were going to become part of the Inspector General because it was recognized that there would be a conflict, as you suggest Mr. Starrett, if those involved in pre-award audit work were also transferred to the Inspector General.

Senator COHEN. Is there defective pricing in negotiated contracts under $500,000, Mr. Vander Schaaf?

Mr. VANDER SCHAAF. Certainly there is some, but I do not know how much there is.

Senator COHEN. Is the GAO correct in stating that without certification, the procuring agency no longer has the legal ammunition to recoup that additional money, that is, the amounts paid to contractors due to proposals in which there were errors contained in the absence of certification? As a matter of practicality, if there is no certification, there is no legal means of enforcing it, is there?

Mr. GORDON. That is correct. With the lack of a certificate of current pricing data, there is no legal base upon which the Government can unilaterally demand and make a decision to reduce the contract price. However, the negotiator may request it in situations below $500,000, as a condition of entering into the contract, even though it is not required by the DAR. There are many instances where he does. Where he has it, even though it is below $500,000, he can unilaterally demand this reduction. There are also instances when mistakes are brought to the attention of contractors which, through bilaterally negotiations of settlement, there is an adjustment downward in price usually because the contractor concedes: there was a mistake, it was not intended, and not equitable. You are correct in your original statement.

Senator COHEN. There is no legal mechanism to enforce it. I will not get into the analysis, but that is sort of tantamount to having taxpayers fill out returns, but not require them to sign their name. The taxpayer would not have to certify that the information contained in his tax return was accurate according to the best of his information. He does not have to sign it, yet he forwards it to the IRS.

Mr. **Gordon**. The point I was trying to make is for most of our larger valued contracts, the contractors do not receive the face value of the contract at the time of award, but receive progress payments which are based upon incurred costs. To the extent that the progress payments are a percentage of the contract price, and the contract price is overstated, he may have been over-financed improperly but only to the extent that he received moneys in full which he must now return. More often than not, these cases are resolved before the contract settlement. There are cases where they are overaged and it is subsequent. We would agree that an interest charge should be imposed but from the date that the Government has determined that it has been overcharged and not from the day of contract award.

Mr. **Vander Schaaf**. I want to clear the record here.

I did not intend to imply that the interest charge would start from the date of contract award. The charge would only be on those payments that are made on the contract that are later found to be defective.

To the extent that the contracting officer relied on defective data, the final price of the contract would be adjusted accordingly, and there would be a percentage reduction from the very first progress payment based on the defective pricing.

Senator **Cohen**. Could I inquire as to whether or not contracts negotiated under $500,000, as a matter of policy, should be exempt from the defective pricing review?

Mr. **Vander Schaaf**. In my opinion, sir, they should not be.

Senator **Cohen**. Are they as a matter of practice?

Mr. **Vander Schaaf**. Effectively, yes, sir, but Mr. Starrett should answer that.

Mr. **Starrett**. I want to make sure that we are talking about proposal reviews because the review of a proposal of $500,000 or less before the contract is placed in our opinion is a very effective use of resources.

When you get to the review after the contract price has been negotiated of a proposal that was negotiated for less than $500,000, to see whether or not the data was accurate, current and complete, that is not very effective.

We have found very little in the way of defective pricing on contracts of $500,000 or less. These are two different audits.

One is at the beginning with the proposal, and is very effective. That is the one that I believe the bill addressed that this committee has. But the review of the contract for possible award for defective pricing afterward is very ineffective.

It is not very cost effective.

Senator **Cohen**. Do you conduct them at random?

How is the comparison arrived at?

Mr. **Starrett**. The procedures that we use provide for, first of all, review of the negotiation memo that we receive under the DAR.

At the time of this review we identify those contracts that to us may be susceptible to defective pricing, things like there was a long period between the review and the time that the price was negotiated allowing for many things to happen in between or other things that indicate defective pricing. Areas that don't seem to be very well supported by the contractor might indicate defective pricing. At the time the review of the negotiation memo we flagged these contracts.

So that in a field audit office they will have certain contracts that they believe are defectively priced. We then program those contracts for review during the year.

The way that we go about programing them is on the basis of a matrix. The matrix includes categories of dollars as well as types of contracts. If it is a firm fixed price contract, for example, and it is over $50 million, we will review it, no question about it, because every dollar that we find of defective pricing in that case is a whole dollar that is returned to the Government.

When you get to the cost-type contracts where there is only a fee involved the risk is much less. We are going to pay the actual amount of a subcontract, for example, even though the original estimate might have been defective. But the only thing that we would recover under defective pricing is the fee. So there is less return on those types of contracts. The program that we have is designed to review those contracts that we feel are most susceptible to defective pricing, those contracts that have larger dollar values where we will get the most for the money invested, and you do not usually get contracts less than $500,000 into that kind of a possible award review matrix.

Senator **Cohen**. Thank you, very much.

Chairman **Roth**. Senator Nunn, did you have any comment?

Senator **Nunn**. Not at this time, Mr. Chairman.

I just want to thank you as I have privately for having these hearings and focusing on this enormously important subject.

I regret I haven't been able to attend as much as I would like, but I have had staff here and your leadership in this area is, I think, invaluable. I congratulate you and Senator Levin, who has worked hard in this area, and Senator Cohen and the others.

I think it is enormously important and I am glad this committee is focusing in on it.

Chairman **Roth**. Thank you, Senator Nunn.

Senator Levin?

Senator **Levin**. Mr. Chairman, let me make sure that we are clear on this.

My amendment refers to the precontract award threshold.

Mr. **Starrett**. That is my understanding.

Senator **Levin**. The threshold would go back to the $100,000 level?

Mr. **Starrett**. That is my understanding.

Senator **Levin**. Do you support that amendment?

Mr. **Starrett**. Yes, sir.

Senator **Levin**. Mr. Vander Schaaf, do you support the amendment?

Mr. **Vander Schaaf**. Yes, sir.

Senator **Levin**. Mr. Gordon?

Mr. **Gordon**. No, sir.

Senator **Levin**. Mr. Chairman, just a couple of other questions.

Do we have an effective way of getting to the subcontractors whose information on pricing is erroneous, just kind of a quick yes or no from the three of you?

Mr. STARRETT. If I might begin that one, it has been something that concerns me.

I am not going to have an answer, and I have been hesitant to bring this up but the public law provides for a downward adjustment of both prime contracts and subcontracts.

However, when you get to the relationship between a prime and a sub, there is no incentive for prime contractors to do any reviews of subcontractors for defective pricing because if that prime contractor were to do that, the prime contract price would likewise be reduced.

So there is no incentive there. As a result we have taken the responsibility upon ourselves to review subcontractors for defective pricing. These subcontracts are included in our matrix along with the prime contracts.

Our problem is identifying all of these subcontracts. We have no real means of making sure that we know of all subcontracts that are subject to Publc Law 87-653, but like I say, I don't know what the answer is.

Mr. VANDER SCHAAF. We would like to make sure that the contracting officer during the negotiations informs the DCAA who the potential subcontractors are on this and request pre-award survey or field pricing support. Our studies so far indicate that we are a little lacking in this area.

We need to tighten up.

Senator LEVIN. Would you give us recommendations for tightening that up?

Mr. Gordon?

Mr. GORDON. I think the problem is exacerbated by the fact that in some instances, the prime has not yet selected all the subs for the subject contract. They are selected following contract award.

I think we have less of a problem at the first tier subcontractor level on the major contracts than we have with the lower tier subcontracts.

A subcontract matrix can become very complex in a major system.

Senator LEVIN. I have one question related to the question by Senator Bingaman on Pratt & Whitney.

There was an auditor involved in that and after he blew the whistle he was transferred to Philadelphia from Florida or proposed to be transferred.

I gather he has filed an appeal of that transfer.

He had a request in for retirement at the time he was transferred. I am wondering if you would tell us for the record, not taking the time of the committee now, but for the record, whether it is not customary that where someone is ready to retire, and has a request for retirement, that one does not apply the usual rotation of 5 years to that person.

If you could submit the answer to that question for the record, it would be appreciated.

Mr. STARRETT. Yes, sir.

Chairman ROTH. The record will be kept open for any written questions.

[The information follows:]

Exemptions to DCAA rotational reassignments include: announced impending retirements, extreme personal, family, or financial hardships, and certain medical situations. DCAA carefully reviews each waiver request submitted to Headquarters by Regional Directors. Waivers are not automatically provided. The Atlanta Region oversees Mr. Spanton's office in West Palm Beach. Since 1979, 14 requests for waivers have been submitted by the Atlanta Region. Eight were approved and six were denied.

For your information, on 21 April 1983, Mr. Spanton's assignment was extended to December 31, 1983 based on his request for retirement.

Chairman ROTH. Again, Mr. Gordon, I was very pleased to hear your comments about the renewed emphasis on competition because I personally feel that that is the best way of getting the lowest price for the Government.

Any other alternative or approach is at best a substitute even though there are situations where admittedly you cannot get competition.

But in any event, I would like to advise you and the others that we will periodically be holding hearings to follow through on the kind of questions we are raising today.

I will be interested to know, and will review this matter again at hearings probably not until early next year, what progress we are making in the area of both competition and defective pricing.

One further comment.

I am also concerned because it is always easy to muddy up the water by bringing in new kinds of figures. So I am going to instruct my staff people to get together with you gentlemen so that in trying to compare what kind of progress we are making in defective pricing, there is a clear understanding of what we are talking about and no difference of opinion or new kinds of figures being submitted.

With that, I want to thank you for being here today.

Mr. GORDON. Thank you very much, sir.

[The prepared statements and responses to written questions of Messrs. Gordon, Starrett, and Vander Schaaf, and responses to questions asked of Joseph Sherick, follow:]

DEPARTMENT OF DEFENSE

STATEMENT
OF

HARVEY J. GORDON
ASSISTANT DEPUTY UNDER SECRETARY OF DEFENSE
FOR ACQUISITION

ON

PUBLIC LAW 87-653, TRUTH IN NEGOTIATIONS ACT

BEFORE THE

SENATE GOVERNMENTAL AFFAIRS COMMITTEE

APRIL 14, 1983

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SUBCOMMITTEE**

GOOD MORNING MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE. I AM PLEASED TO HAVE THE OPPORTUNITY TO APPEAR BEFORE YOU TODAY TO PRESENT MY VIEWS ON P.L. 87-653. P.L. 87-653, COMMONLY REFERRED TO AS THE TRUTH IN NEGOTIATIONS ACT BECAME EFFECTIVE ON DECEMBER 1, 1962. THE ACT PROVIDES THAT PRIME CONTRACTORS AND SUBCONTRACTORS SHALL BE REQUIRED TO SUBMIT COST OR PRICING DATA AND TO CERTIFY THAT DATA SUBMITTED ARE ACCURATE, COMPLETE AND CURRENT PRIOR TO THE AWARD OF NEGOTIATED CONTRACTS, CONTRACT MODIFICATIONS AND SUBCONTRACTS EXPECTED TO EXCEED $100,000 (THIS THRESHOLD WAS INCREASED TO $500,000 BY P.L. 97-86 ON DECEMBER 1, 1981) UNLESS THE PRICE NEGOTIATED IS BASED ON ADEQUATE PRICE COMPETITION, ESTABLISHED CATALOG OR MARKET PRICES OF COMMERCIAL ITEMS SOLD IN SUBSTANTIAL QUANTITIES TO THE GENERAL PUBLIC, PRICES SET BY LAW OR REGULATION OR, IN EXCEPTIONAL CASES, WHERE THE HEAD OF THE AGENCY DETERMINES THAT THE REQUIREMENT MAY BE WAIVED AND STATES IN WRITING THE REASONS FOR SUCH DETERMINATION. ANY PRIME CONTRACT, CHANGE OR MODIFICATION THERETO UNDER WHICH SUCH CERTIFICATION IS REQUIRED SHALL CONTAIN A PROVISION THAT THE PRICE TO THE GOVERNMENT, INCLUDING PROFIT OR FEE, SHALL BE ADJUSTED TO EXCLUDE ANY SIGNIFICANT SUMS BY WHICH IT MAY BE DETERMINED BY THE HEAD OF THE AGENCY THAT SUCH PRICE WAS INCREASED BECAUSE THE CONTRACTOR OR ANY SUBCONTRACTOR REQUIRED TO FURNISH SUCH A CERTIFICATE, FURNISHED COST OR PRICING DATA WHICH, AS OF A DATE AGREED UPON BETWEEN THE PARTIES (WHICH DATA SHALL BE AS CLOSE TO THE DATE OF AGREEMENT ON THE NEGOTIATED PRICE AS PRACTICABLE), WAS INACCURATE, INCOMPLETE, OR NONCURRENT.

AT THIS POINT, I WOULD LIKE TO COMMENT ON WHY DOD SUBMITTED A LEGISLATIVE PROPOSAL TO INCREASE THE THRESHOLD FOR OBTAINING COST OR PRICING DATA FROM $100,000 TO $500,000. FIRST, WE PROPOSED THE INCREASE FROM $100,000 TO $500,000, IN PART, TO ACCOUNT FOR THE IMPACT OF INFLATION THAT HAS OCCURRED IN THE NATIONAL ECONOMY, SINCE THE INCEPTION OF THE "TRUTH-IN-NEGOTIATIONS" ACT IN 1962. SECONDLY, TO AMELIORATE PAPERWORK BURDENS ON CONTRACTORS AND TO PERMIT MORE EFFICIENT USE OF DOD RESOURCES. INCREASING THE THRESHOLD TO $500,000 HAS SIGNIFICANTLY REDUCED FOR THE GOVERNMENT AND ITS CONTRACTORS THE VOLUME OF PAPERWORK INCIDENT TO ADMINISTERING THE REQUIREMENTS OF THE ACT. THE INCREASED THRESHOLD, HOWEVER, HAS NOT DIMINISHED THE VALUE OF THE ACT BECAUSE THE TOTAL DOLLAR VALUE OF DOD PROCUREMENT SUBJECT TO THE ACT HAS BEEN REDUCED BY A RELATIVELY INSIGNIFICANT AMOUNT. AT THAT TIME WE REPORTED THAT CERTIFIED COST OR PRICING DATA WERE SUBMITTED AND CONSIDERED IN 7,034 PROCUREMENT ACTIONS INVOLVING MORE THAN $100,000 FOR A TOTAL OF APPROXIMATELY $15.6 BILLION. OF THOSE 7,034 ACTIONS, 2,442 INVOLVED MORE THAN $500,000 AND HAD A VALUE OF ABOUT $14.5 BILLION. THUS, WITH A 65 PERCENT REDUCTION IN PAPERWORK REQUIREMENTS, WE COULD CONTINUE TO COVER OVER 93.4 PERCENT OF THE EXPENDITURES THAT WERE SUBJECT TO THIS REQUIREMENT. AN UPDATE OF THIS INFORMATION FOR THE LAST TWO FISCAL YEARS SHOWS THAT WE HAD 65,666 ACTIONS INVOLVING MORE THAN $100,000 FOR A TOTAL OF APPROXIMATELY $73.8 BILLION. OF THOSE 65,666 ACTIONS, 13,752 INVOLVED MORE THAN $500,000 AND HAD A VALUE OF ABOUT $68 BILLION.

THEREFORE, WITH A 79 PERCENT REDUCTION IN PAPERWORK REQUIREMENTS, WE COULD CONTINUE TO COVER OVER 92 PERCENT OF THE EXPENDITURES AFTER RAISING THE THRESHOLD FROM $100,000 TO $500,000.

AT THIS POINT, I WOULD LIKE TO CLARIFY FOR THE RECORD, A STATEMENT CONTAINED IN PARAGRAPH 7 OF SENATOR ROTH'S LETTER TO THE UNDER SECRETARY OF DEFENSE (RESEARCH & ENGINEERING) DATED APRIL 4, 1983. IN DISCUSSING "CARLUCCI'S INITIATIVE" NUMBER 10 DEALING IN PART WITH SECURING CONGRESSIONAL APPROVAL TO RAISE THE P.L. 87-653 THRESHOLD FROM $100,000 TO $500,000, SENATOR ROTH'S LETTER STATED THAT PART OF THE DOD RECOMMENDATION WAS BASED ON THE FACT THAT CONTRACT AUDITORS WERE SUPPOSEDLY NO LONGER AUDITING CONTRACTORS' PRICING PROPOSALS UNDER $500,000. AS A MATTER OF FACT, "CARLUCCI'S INITIATIVE" NUMBER 10 STATED THAT, "PAPERWORK LOAD IS SUCH THAT ONLY DATA FOR CONTRACTS OVER $500,000 IS ACTUALLY AUDITED TODAY." THERE IS A SIGNIFICANT DIFFERENCE BETWEEN THE AUDIT REVIEW OF A PRICE PROPOSAL PRIOR TO CONTRACT AWARD, AND THE SUBSEQUENT AUDIT OF THE RESULTING CONTRACT FOR DEFECTIVE PRICING. WE BELIEVE THAT THE RECENT DCAA RESPONSE TO THIS COMMITTEE, ON THE SUBJECT OF DEFECTIVE PRICING, CONFIRMED THAT DCAA HAS REVIEWED FEW, IF ANY, CONTRACTS UNDER $500,000 FOR DEFECTIVE PRICING.

WE VIEW THE INTENT OF THE LAW TO BE TWOFOLD. FIRST, TO AVOID OVER PRICING OF CONTRACTS BY ASSURING THAT THE GOVERNMENT AND THE CONTRACTOR HAVE EQUAL KNOWLEDGE OF THE FACTS AFFECTING THE PRICING OF THE CONTRACT. SECONDLY, IN THE EVENT THE CONTRACT WAS OVERPRICED AS A RESULT OF INACCURATE, INCOMPLETE OR NONCURRENT DATA, THE GOVERNMENT IS ENTITLED TO A DOWNWARD PRICE ADJUSTMENT IN THE CONTRACT PRICE.

WE HAVE IMPLEMENTED THE LAW THROUGH OUR DEFENSE ACQUISITION REGULATION (DAR). THE IMPLEMENTATION WAS ACCOMPLISHED IN FOUR MAJOR SEGMENTS: (1) THE PRE-PROPOSAL EFFORT, (2) THE PROPOSAL EVALUATION PROCESS, (3) THE CONTRACT NEGOTIATION PHASE, AND (4) THE POST-AWARD PHASE. I WILL ADDRESS THESE AREAS IN MORE DETAIL IN ORDER THAT YOU WILL HAVE A COMPLETE UNDERSTANDING OF HOW THE ACT HAS BEEN IMPLEMENTED.

PRE-PROPOSAL EFFORT. PRIOR TO REQUESTING A PRICE PROPOSAL FROM A CONTRACTOR, THE CONTRACTING OFFICER PREPARES A DOCUMENT TITLED "REQUEST FOR PROPOSALS." DETAILED INSTRUCTIONS ON THE PREPARATION OF THIS DOCUMENT IS INCLUDED IN DAR, SECTION III, PART 5. THESE INSTRUCTIONS TO THE CONTRACTING OFFICER PROVIDE GUIDANCE TO INSURE THAT ANY SUBSEQUENT CONTRACT COMPLIES WITH ALL APPLICABLE LAWS AND REGULATIONS ISSUED BY THE DOD. FOR EXAMPLE, WITH RESPECT TO P.L. 87-653 THE REQUEST FOR PROPOSAL WILL INCLUDE A DESCRIPTION OF ANY INFORMATION REQUIRED TO SUPPORT PROPOSED PRICES. AS A MINIMUM, IT WILL INSTRUCT THE CONTRACTOR TO SUBMIT ITS PROPOSAL ON A STANDARD FORM DD-633, DEPARTMENT OF DEFENSE CONTRACT PRICING PROPOSAL. THE PURPOSE OF THIS STANDARD FORM IS TO PROVIDE A VEHICLE WHEREBY THE OFFEROR SUBMITS TO THE GOVERNMENT A PRICING PROPOSAL OF ESTIMATED AND/OR INCURRED COSTS BY CONTRACT LINE ITEM WITH SUPPORTING INFORMATION, ADEQUATELY CROSS-REFERENCED, SUITABLE FOR DETAILED ANALYSIS. THE FORM ITSELF PROVIDES DETAILED INSTRUCTIONS ON THE TYPE AND EXTENT OF DATA REQUIRED. IN ADDITION, THE DD 633 FORM MUST BE SIGNED BY AN OFFICIAL OF THE COMPANY. IT ALSO CONTAINS A PROVISION WHEREBY, THE OFFEROR, IF SELECTED FOR NEGOTIATIONS, GRANTS TO THE

CONTRACTING OFFICER, OR HIS AUTHORIZED REPRESENTATIVE, THE RIGHT TO EXAMINE THOSE BOOKS, RECORDS, DOCUMENTS AND OTHER SUPPORTING DATA WHICH WILL PERMIT ADEQUATE EVALUATION OF THE PROPOSED PRICE. THE FORM ALSO CONTAINS A PROVISION THAT THE OFFEROR SHALL SUBMIT A CERTIFICATE OF CURRENT COST OR PRICING DATA UPON CONCLUSIONS OF THE NEGOTIATIONS AND THE DATE UPON WHICH THE PRICE WAS AGREED TO BY THE PARTIES.

THE REQUEST FOR PROPOSAL IDENTIFIES THE CLAUSES THAT WILL BE REQUIRED TO BE INCLUDED IN ANY SUBSEQUENT CONTRACT. WITH RESPECT TO P.L. 87-653, THE PERTINENT CLAUSES ARE:

1. PRICE REDUCTION FOR DEFECTIVE COST OR PRICING DATA (DAR 7-104.29). BRIEFLY, THIS CLAUSE GIVES THE GOVERNMENT A RIGHT TO A DOWNWARD ADJUSTMENT TO THE CONTRACT PRICE IF IT IS DETERMINED THAT COST OR PRICING DATA SUBMITTED WAS NOT COMPLETE, ACCURATE AND CURRENT AS CERTIFIED IN THE CONTRACTOR'S CERTIFICATE OF CURRENT COST OR PRICING DATA.

2. SUBCONTRACTOR COST OR PRICING DATA (DAR 7-104.42). THIS CLAUSE STATES THAT THE CONTRACTOR SHALL REQUIRE SUBCONTRACTORS TO SUBMIT COST OR PRICING DATA AND THAT SUCH DATA BE CERTIFIED BY THE SUBCONTRACTOR. THIS CLAUSE ALSO REQUIRES THAT THE CONTRACTOR SHALL INSERT THE SUBSTANCE OF THIS CLAUSE IN EACH SUBCONTRACT WHICH EXCEEDS $500,000.

3. AUDIT BY DEPARTMENT OF DEFENSE (DAR 7-104.41). IF THE CONTRACTOR SUBMITTED COST OR PRICING DATA IN CONNECTION WITH THE PRICING OF THIS CONTRACT OR ANY CHANGE OR MODIFICATION THERETO WHEN COST OR PRICING DATA WAS REQUIRED, THE CONTRACTING OFFICER OR HIS REPRESENTATIVES WHO ARE EMPLOYEES OF THE UNITED STATES

GOVERNMENT SHALL HAVE THE RIGHT TO EXAMINE ALL BOOKS, RECORDS, DOCUMENTS AND OTHER DATA OF THE CONTRACTOR RELATED TO THE NEGOTIATION, PRICING OR PERFORMANCE OF SUCH CONTRACT, CHANGE OR MODIFICATION FOR THE PURPOSE OF EVALUATING THE ACCURACY, COMPLETENESS AND CURRENCY OF THE COST OR PRICING DATA SUBMITTED.

WE NOW SEE THAT THE REQUEST FOR PROPOSAL IS A KEY DOCUMENT USED BY DOD TO INSURE THAT WE REQUEST ADEQUATE COST OR PRICING DATA PURSUANT TO P.L. 87-653, THAT REQUIRED CONTRACT CLAUSES ARE IDENTIFIED FOR INCLUSION IN ANY RESULTANT CONTRACT AND THAT THE CONTRACTOR IS MADE AWARE OF THE REQUIREMENT OF CERTIFICATION OF THE COST OR PRICING DATA.

PROPOSAL EVALUATION EFFORT. AFTER RECEIPT OF THE CONTRACTOR'S PROPOSAL, THE CONTRACTING OFFICER INITIATES THE PROPOSAL EVALUATION PROCESS. THE BASIC POLICY OF THE DOD IS TO PROCURE SUPPLIES AND SERVICES FROM RESPONSIBLE SOURCES AT FAIR AND REASONABLE PRICES CALCULATED TO RESULT IN THE LOWEST OVERALL COST TO THE GOVERNMENT. TO ACHIEVE THIS OBJECTIVE, THE CONTRACTING OFFICER MUST ADHERE TO OUR POLICIES AND PROCEDURES WHICH ARE DESIGNED TO PROVIDE THE FRAMEWORK FOR A COMPREHENSIVE EVALUATION OF THE CONTRACTOR'S PROPOSAL. EACH CONTRACTING OFFICER IS RESPONSIBLE FOR PERFORMING OR HAVING PERFORMED ALL ADMINISTRATIVE ACTIONS NECESSARY FOR EFFECTIVE CONTRACTING. THE CONTRACTING OFFICER SHALL AVAIL HIMSELF OF ALL APPROPRIATE ORGANIZATIONAL TOOLS SUCH AS THE ADVICE OF SPECIALISTS IN THE FIELDS OF CONTRACTING, FINANCE, LAW, CONTRACT AUDIT, PACKAGING, ENGINEERING, TRAFFIC MANAGEMENT, AND PRICE ANALYSIS. TO THE

EXTENT SERVICES OF SPECIALISTS ARE UTILIZED IN THE NEGOTIATION OF CONTRACTS, THE CONTRACTING OFFICER MUST COORDINATE A TEAM OF EXPERTS, REQUESTING ADVICE FROM THEM, EVALUATING THEIR COUNSEL, AND AVAILING HIMSELF OF THEIR SKILLS. HE SHALL NOT, HOWEVER, TRANSFER HIS OWN RESPONSIBILITY TO THEM. THEREFORE, THE DETERMINATION OF THE SUITABILITY OF THE CONTRACT PRICE TO THE GOVERNMENT ALWAYS REMAINS THE RESPONSIBILITY OF THE CONTRACTING OFFICER. I WANT TO EMPHASIZE HERE, EVEN THOUGH THE CONTRACTING OFFICER HAS THE RESPONSIBILITY FOR THE CONTRACT PRICE, HE CANNOT SIMPLY JUST DISREGARD THE ADVICE RECEIVED FROM THE VARIOUS SPECIALISTS SUCH AS THE CONTRACT AUDITOR. ON THE CONTRARY, WE HAVE A NUMBER OF CHECKS AND BALANCES BUILT INTO OUR PROCUREMENT PROCESS TO ALLOW SIGNIFICANT DIFFERENCES OF OPINION TO SURFACE AND BE RESOLVED IN THE BEST INTEREST OF THE OVERALL PROCUREMENT ACTION.

PRIOR TO NEGOTIATION OF A CONTRACT OR MODIFICATION RESULTING FROM A PROPOSAL IN EXCESS OF $500,000, WHEN THE PRICE IS BASED ON COST OR PRICING DATA SUBMITTED BY THE CONTRACTOR, THE CONTRACTING OFFICER SHALL REQUEST A FIELD PRICING REPORT (WHICH USUALLY INCLUDES AN AUDIT REVIEW BY THE CONTRACT AUDIT ACTIVITY), UNLESS INFORMATION ALREADY AVAILABLE TO THE CONTRACTING OFFICER IS CONSIDERED ADEQUATE TO DETERMINE THE REASONABLENESS OF THE PROPOSED COST OR PRICE. WHENEVER AVAILABLE DATA IS CONSIDERED ADEQUATE FOR A REASONABLENESS DETERMINATION, THE CONTRACTING OFFICER SHALL DOCUMENT THE CONTRACT FILE TO REFLECT THE BASIS OF THE DETERMINATION. THIS EXCEPTION IS NOT OFTEN USED BY THE

CONTRACTING OFFICER AND I DO NOT RECALL ANY VIOLATIONS OF POLICY IN THIS RESPECT BEING REPORTED BY EITHER OUR INTERNAL AUDITORS OR THE GENERAL ACCOUNTING OFFICE.

AT THIS POINT, I WOULD LIKE TO COMMENT ON THE $500,000 THRESHOLD FOR MANDATORY FIELD PRICING REPORTS. PRIOR TO DECEMBER 27, 1982, THE THRESHOLDS FOR FIELD PRICING REVIEWS WERE AS FOLLOWS:

1. $100,000 FOR FIRM FIXED-PRICE PROPOSALS;
2. $250,000 FOR FIXED-PRICE INCENTIVE AND COST PLUS INCENTIVE FEE PROPOSALS; AND
3. $500,000 FOR COST REIMBURSEMENT PROPOSALS.

DOD CHANGED THE THRESHOLD FOR MANDATORY FIELD PRICING REPORTS TO $500,000 FOR ALL CONTRACT TYPES ON DECEMBER 27, 1982. WHAT WE HAVE DONE IS SIMPLY TO ALLOW THE CONTRACTING OFFICER TO EXERCISE HIS JUDGMENT IN WHETHER OR NOT A FIELD PRICING REPORT IS NEEDED FOR PROCUREMENTS OF LESS THAN $500,000. THE DAR CLEARLY STATES THE RESPONSIBILITY OF THE CONTRACTING OFFICER. DAR 3-801.2 STATES IN PART, "EACH CONTRACTING OFFICER IS RESPONSIBLE FOR PERFORMING OR HAVING PERFORMED ALL ADMINISTRATIVE ACTIONS NECESSARY FOR EFFECTIVE CONTRACTING. THE CONTRACTING OFFICER SHALL AVAIL HIMSELF OF ALL APPROPRIATE ORGANIZATIONAL TOOLS SUCH AS THE ADVICE OF SPECIALISTS IN THE FIELDS OF CONTRACTING, FINANCE, LAW, CONTRACT AUDIT, PACKAGING, ENGINERING, TRAFFIC MANAGEMENT, AND PRICE ANALYSIS." IT CAN READILY BE SEEN FROM THIS CHARGE THAT WHETHER OR NOT THE CONTRACTING OFFICER OBTAINS A FIELD PRICING REPORT DOES NOT, IN ANY WAY, RELIEVE HIM FROM THE RESPONSIBILITY FOR EFFECTIVE CONTRACTING.

IN MANY PROCUREMENTS, LESS THAN A COMPLETE COST ANALYSIS (E.G., ANALYSIS OF ONLY SPECIFIC FACTORS) WILL PROVIDE A REASONABLE PRICING RESULT ON AWARDS UNDER $500,000 WITHOUT THE SUBMISSION OF COMPLETE COST OR PRICING DATA. IN SUCH CASES, THE CONTRACTING OFFICER MAY REQUEST ONLY THAT DATA WHICH HE CONSIDERS ADEQUATE TO SUPPORT THE LIMITED EXTENT OF THE COST ANALYSIS REQUIRED. I WOULD LIKE TO MENTION AT THIS POINT, THAT WHEN THE THRESHOLD WAS $100,000, THE CONTRACTING OFFICER WAS ALSO REQUIRED TO EXERCISE HIS JUDGMENT IN DETERMINING THE EXTENT TO WHICH FIELD PRICING SUPPORT WAS NEEDED.

WHILE IT IS TRUE THE THRESHOLD FOR "CERTIFIED" COST OR PRICING DATA HAS BEEN INCREASED TO $500,000, THIS DOES NOT PRECLUDE SUBMISSION OF COST OR PRICING DATA. IN FACT, ADEQUATE DATA ARE REQUIRED TO SUPPORT PROPOSALS UNDER $500,000, ONLY NOW THEY DO NOT HAVE TO BE CERTIFIED.

THE ASSUMPTION, MADE BY SOME GROUPS, THAT WITHOUT CERTIFIED COST OR PRICING DATA AND FIELD PRICING REPORTS ON PROCUREMENTS UNDER $500,000, THAT NEGOTIATED SAVINGS ON INDIVIDUAL PROPOSALS WILL NO LONGER BE REALIZED IS NOT VALID. CONTRACTING OFFICERS WILL STILL OBTAIN AUDITS AND OTHER FIELD REVIEWS IN THOSE CASES WHERE THEY BELIEVE IT IS NECESSARY. IN ADDITION, THEY WILL UTILIZE APPROVED FORWARD PRICING RATES FOR LABOR AND OVERHEAD IN DETERMINING THE REASONABLENESS OF THE PROPOSED COSTS. THEREFORE, WE DO NOT ANTICIPATE ANY SIGNIFICANT DIFFERENCE IN THE RESULTS OF OUR NEGOTIATIONS OF CONTRACTS UNDER $500,000 AS A RESULT OF THE CHANGE IN THE THRESHOLD. WE DO, HOWEVER, EXPECT THAT THE CHANGE WILL RESULT IN AN IMPROVEMENT IN THE NEGOTIATED CONTRACT PRICES

FOR THOSE PROCUREMENTS EXCEEDING $500,000 BECAUSE MORE DCAA AND PLANT REPRESENTATIVE RESOURCES ARE NOW AVAILABLE FOR EVALUATING AND NEGOTIATING THESE LARGER DOLLAR VALUE PROCUREMENTS.

THE GOVERNMENT PLANT REPRESENTATIVE OR THE ADMINISTRATIVE CONTRACTING OFFICER (ACO), AS WELL AS THE CONTRACT AUDITOR, IS RESPONSIBLE FOR PROVIDING A COMPLETE AND ACCURATE FIELD PRICING REPORT TO THE PROCURING CONTRACTING OFFICER (PCO). A FIELD PRICING REPORT CONTAINS THE ANALYSIS OF CONTRACTOR PRICING PROPOSALS BY ANY OR ALL FIELD TECHNICAL AND OTHER SPECIALISTS, INCLUDING PLANT REPRESENTATIVES, ADMINISTRATIVE CONTRACTING OFFICERS, CONTRACT AUDITORS AND PRICE ANALYSTS. THE SUMMARY FIELD PRICING REPORT PREPARED BY THE ACO WILL NORMALLY INCLUDE A DCAA AUDIT REPORT AND A TECHNICAL ANALYSIS REPORT.

THE AUDIT REPORT WILL NORMALLY CONTAIN A SUMMARY OF THE CONTRACTOR'S PROPOSED COSTS AND THE AUDITORS EVALUATION OF THAT COST. THE AUDITOR WILL SET FORTH THE BASIS AND METHOD USED BY THE CONTRACTOR IN PREPARING THE PROPOSAL AND WILL ALSO COMMENT ON THE ADEQUACY OF THE COST OR PRICING DATA SUBMITTED IN SUPPORT OF THE PROPOSAL. THE AUDIT REPORT WILL CONTAIN SPECIFIC COMMENTS IN THOSE AREAS WHERE THE AUDITOR TAKES EXCEPTION TO OR QUESTIONS CERTAIN COSTS. THE AUDITOR WILL QUANTIFY THESE COSTS IN TERMS OF DOLLARS QUESTIONED. THE AUDITOR IS NORMALLY RESPONSIBLE FOR REVIEWING THE FINANCIAL OR COST ASPECTS OF THE PROPOSAL. THIS WOULD INCLUDE SUCH THINGS AS MATERIAL PRICES, LABOR RATES, OVERHEAD OR G&A RATES AND OTHER DIRECT COST SUCH AS COMPUTER RATES AND TRAVEL EXPENSE. WHEN THE TECHNICAL EVALUATION REPORT

IS AVAILABLE PRIOR TO ISSUANCE OF THE AUDIT REPORT, THE AUDIT REPORT WILL NORMALLY INCORPORATE THE FINANCIAL IMPACT OF THE RECOMMENDATIONS CONTAINED THEREIN.

TECHNICAL ANALYSIS REPORTS ARE NEEDED TO ESTABLISH THE REASONABLENESS OF THE QUANTITATIVE FACTORS CONTAINED IN THE PROPOSAL (LABOR HOURS AND SKILL MIX, TYPES AND QUANTITIES OF MATERIAL, COMPUTER AND TRAVEL REQUIREMENTS, ETC.). THE OVERALL REASONABLENESS OF THE PROPOSAL CANNOT BE ESTABLISHED WITHOUT AN EFFECTIVE TECHNICAL ANALYSIS OF THE QUANTITATIVE FACTORS INCLUDED IN THE PROPOSALS. TECHNICAL PERSONNEL USUALLY PERFORM THE ANALYSIS AT THE EARLIEST POSSIBLE DATE, AND, WHERE PRACTICABLE, AT LEAST 5 DAYS PRIOR TO THE DUE DATE OF THE AUDIT REPORT. WELL-STRUCTURED TECHNICAL ANALYSIS REPORTS OF CONTRACTORS' PROPOSALS THAT PRESENT INFORMATION IN A CONCISE MEANINGFUL MANNER ARE A VALUABLE TOOL FOR THE SUPPORT OF CONTRACT NEGOTIATIONS. THE TECHNICAL ANALYSIS OF THE COST PROPOSAL IS NECESSARY TO ASSIST TECHNICAL PERSONNEL IN EVALUATING THE OFFEROR'S UNDERSTANDING OF TECHNICAL REQUIREMENTS AND THE QUALITY OF THE TECHNICAL PROPOSAL, AS WELL AS TO ASSIST THE CONTRACTING OFFICER IN ESTABLISHING THE REASONABLENESS OF THE CONTRACT PRICE. TO ACCOMPLISH THIS END THE ACO MUST:

1. IN CONCERT WITH THE AUDITOR, ESTABLISH A DUE DATE FOR THE AUDITOR'S REPORT;

2. IDENTIFY AREAS OF THE CONTRACTOR'S PROPOSAL FOR SPECIAL CONSIDERATION (THESE WOULD BE IN ADDITION TO THOSE ALREADY SPECIFIED BY THE PCO);

3. ARRANGE FOR EXCHANGE OF TECHNICAL AND AUDIT INFORMATION AND COORDINATION BETWEEN THE CONTRACT ADMINISTRATION SERVICES AND AUDIT ACTIVITIES; AND

4. BE FULLY RESPONSIVE TO ANY REQUEST FOR TECHNICAL INFORMATION FROM THE AUDITOR.

WHEN PROVIDING PRICING SUPPORT TO THE PCO, THE PLANT REPRESENTATIVE OR ACO HAS THE PRIMARY RESPONSIBILITY FOR CONSOLIDATING AND EVALUATING THE FINDINGS OF THE PRICING TEAM MEMBERS AT THE CONTRACT ADMINISTRATION AND CONTRACT AUDIT OFFICES.

THE CONTRACT AUDITOR IS RESPONSIBLE FOR SUBMISSION OF INFORMATION AND ADVICE, BASED ON HIS ANALYSIS OF THE CONTRACTOR'S BOOKS AND ACCOUNTING RECORDS, AS TO THE ACCEPTABILITY OF THE CONTRACTOR'S INCURRED AND ESTIMATED COSTS. THE AUDITOR IS RESPONSIBLE FOR PERFORMING THAT PART OF THE REVIEW AND COST ANALYSIS WHICH REQUIRES ACCESS TO THE CONTRACTOR'S BOOKS AND FINANCIAL RECORDS SUPPORTING COST OR PRICING DATA. THE SCOPE AND DEPTH OF THE AUDIT IS THE RESPONSIBILITY OF THE CONTRACT AUDITOR. HOWEVER, THE AUDITOR SHALL ALSO ACCOMMODATE ANY SPECIFIC REQUEST MADE BY THE PCO. THE AUDIT REPORT SETS FORTH THE BASIS AND METHOD USED BY THE CONTRACTOR IN PREPARING THE PRICE PROPOSAL. ALSO, THE REPORT CLEARLY IDENTIFIES THE CONTRACTOR'S PROPOSAL AND ALL SUBSEQUENT WRITTEN FORMAL SUBMISSIONS TO THE CONTRACTING OFFICER OR TO THE AUDITOR BY WHICH COST OR PRICING DATA WAS FURNISHED OR IDENTIFIED BY THE CONTRACTOR. IN ADDITION, COST OR PRICING DATA NOT SUBMITTED BY THE CONTRACTOR BUT OTHERWISE COMING TO THE AUDITOR WHICH HAVE A SIGNIFICANT EFFECT ON THE PROPOSED

COST OR PRICE IS ALSO DESCRIBED IN THE AUDIT REPORT. IF THE AUDITOR CONSIDERS THAT THE COST OR PRICING DATA SUBMITTED BY THE CONTRACTOR ARE NOT ACCURATE, COMPLETE AND CURRENT, OR THAT REPRESENTATIONS ARE UNSUPPORTED, THIS INFORMATION IS MADE KNOWN IN THE AUDIT REPORT. WHEN THE RESULTING OVERALL EFFECT OF THOSE DEFICIENCIES ON THE PROPOSED COST OR PRICE IS OF SUCH MAGNITUDE THAT THE USEFULNESS OF THE CONTRACTOR'S PROPOSAL IS CONSIDERABLY IMPAIRED AS A BASIS FOR NEGOTIATIONS, THE CONTRACTING OFFICER IS ADVISED PROMPTLY TO ENABLE CORRECTIVE ACTION TO PROCEED WITHOUT DELAY. THE CONTROL FEATURES IN OUR PROCEDURES DO NOT RELIEVE THE CONTRACTOR OF HIS OBLIGATION TO SUBMIT ACCURATE, COMPLETE AND CURRENT COST OR PRICING DATA.

THE AUDITOR'S COMPLETED REPORT SHALL BE SENT TO THE PLANT REPRESENTATIVE OR ACO FOR INCLUSION, WITHOUT CHANGE, IN THE FIELD PRICING REPORT TO THE PCO. THE FIELD PRICING REPORT THEN BECOMES A PART OF THE OFFICIAL CONTRACT FILE. SINCE THE CONTRACT AUDITOR IS INDEPENDENT ORGANIZATIONALLY FROM EITHER THE PLANT REPRESENTATIVE/ACO OR THE PCO; DETERMINES THE DEPTH AND SCOPE OF THE CONTRACT AUDIT; AND A COPY OF HIS REPORT IS CONTAINED IN THE CONTRACT FILE, THIS PROVIDES A SIGNIFICANT INTERNAL CONTROL MECHANISM IN THE PROCUREMENT PROCESS.

IN ADDITION, DOD DIRECTIVE NUMBER 7640.2 (FORMERLY DOD DIRECTIVE 5000.42 ISSUED AUGUST 31, 1981) TITLED, "POLICY FOR FOLLOW-UP ON CONTRACT AUDIT REPORTS" PROVIDES A SYSTEM FOR (A) TRACKING AND REPORTING SPECIFIED TYPES OF CONTRACT AUDIT REPORTS: (B) A PROCEDURE TO REVIEW DIFFERENCES ON THE RESOLUTION OF CONTRACT AUDIT RECOMMENDATIONS: AND (C) AN EVALUATION OF THE EFFECTIVENESS OF THE DOD COMPONENTS' FOLLOW-UP SYSTEMS.

WHEN THE CONTRACTING OFFICER'S PROPOSED DISPOSITION OF CONTRACT AUDIT REPORT RECOMMENDATIONS DIFFERS FROM THE CONTRACT AUDITOR'S REPORT RECOMMENDATIONS IN PRENEGOTIATION OBJECTIVES FOR FORWARD PRICING ACTIONS, WHEN QUESTIONED COSTS TOTAL AT LEAST $500,000, AND UNRESOLVED DIFFERENCES BETWEEN THE AUDITOR AND CONTRACTING OFFICER TOTAL AT LEAST FIVE PERCENT OF THE TOTAL QUESTIONED COSTS: THE CONTRACTING OFFICER'S PROPOSED DISPOSITION SHALL BE BROUGHT PROMPTLY TO THE ATTENTION OF A DESIGNATED INDEPENDENT SENIOR ACQUISITION OFFICIAL OR BOARD FOR REVIEW. THIS SENIOR OFFICIAL OR BOARD WILL RECEIVE FOR REVIEW, ALONG WITH OTHER TECHNICAL MATERIALS, THE CONTRACT AUDITOR'S REPORT. THE OFFICIAL OR BOARD SHALL GIVE CAREFUL CONSIDERATION TO RECOMMENDATIONS OF THE AUDITORS, AS WELL AS THE RECOMMENDATIONS RENDERED BY OTHER MEMBERS OF THE CONTRACTING OFFICER'S TEAM, IN REVIEWING THE POSITION OF THE CONTRACTING OFFICER. THE OFFICIAL OR BOARD SHALL PROVIDE TO THE CONTRACTING OFFICER, WITH A COPY TO THE CONTRACT AUDITOR, A CLEAR, WRITTEN RECOMMENDATION CONCERNING ALL MATTERS SUBJECT TO REVIEW. AS A MATTER OF INFORMATION, THESE PROCEDURES ALSO APPLY TO ALL AUDIT REPORTS COVERING DEFECTIVE PRICING, ESTIMATING SYSTEM SURVEYS, ACCOUNTING SYSTEM REVIEWS, INTERNAL CONTROL REVIEWS, COST ACCOUNTING STANDARDS NONCOMPLIANCE REVIEWS, AND OPERATIONAL AUDITS. ALSO INCLUDED ARE AUDIT REPORTS COVERING INCURRED COSTS, SETTLEMENT OF INDIRECT COST RATES, FINAL PRICINGS, TERMINATIONS, EQUITABLE ADJUSTMENT CLAIMS, HARDSHIP CLAIMS, AND ESCALATION CLAIMS IF TOTAL COSTS QUESTIONED EQUAL $50,000 OR MORE AND DIFFERENCES BETWEEN THE CONTRACTING OFFICER AND AUDITOR TOTAL AT LEAST FIVE PERCENT OF QUESTIONED COSTS.

THE AUDIT FOLLOW-UP REGULATION REQUIRES THAT THE CONTRACTING OFFICER TO PREPARE A MEMORANDUM COVERING THE DISPOSITION OF ALL AUDIT REPORTS. THE MEMORANDUM SHALL DISCUSS THE DISPOSITION OF ALL AUDIT REPORT RECOMMENDATIONS, INCLUDING THE UNDERLYING RATIONALE FOR SUCH DISPOSITIONS. IN THE EVENT A SENIOR OFFICIAL OR BOARD REVIEW WAS OBTAINED, THE MEMORANDUM ALSO SHALL DISCUSS THE DISPOSITION OF THE SENIOR OFFICIAL OR BOARD RECOMMENDATIONS. A COPY OF THE MEMORANDUM SHALL BE PROVIDED TO THE COGNZANT CONTRACT AUDITOR AND TO THE SENIOR OFFICIAL OR BOARD MAKING THE REVIEW.

AFTER THE PROPOSAL EVALUATION PROCESS IS COMPLETED, THE NEXT STEP IS THE CONTRACT NEGOTIATIONS ITSELF.

CONTRACT NEGOTATION PHASE. THE PRICE NEGOTIATION PHASE OF THE PROCUREMENT CYCLE IS GENERALLY THOUGHT TO INCLUDE ESTABLISHING THE PRICE OBJECTIVE, OBTAINING MANAGEMENT APPROVAL OF THE PRICE OBJECTIVE, CONDUCTING THE NEGOTIATION CONFERENCE, REACHING AGREEMENT ON PRICE, OBTAINING A CERTIFICATE OF CURRENT COST OR PRICING DATA, AND PREPARING A RECORD OF THE NEGOTIATIONS.

TO DEVELOP THE PRICE NEGOTIATION OBJECTIVE, THE PCO WILL START OUT WITH THE COST VALUES INCLUDED IN THE CONTRACTOR'S PROPOSAL. THE ANALYSIS CONDUCTED DURING THE PROPOSAL EVALUATION PHASE SHOULD HAVE RESOLVED THE QUESTIONS OF FACT AND ALL DISAGREEMENTS ABOUT COST OR PRICING DATA. THE REMAINING AREAS OF DISAGREEMENT WILL BE IDENTIFIED AND THE DOLLARS AT ISSUE IDENTIFIED. THE DIFFERENCES THAT NOW EXISTS ARE THE DIFFERENCES OF OPINION AS TO WHAT WILL HAPPEN AND THE SIGNIFICANCE OF

PARTICULAR FACTS. POINTS OF VIEW ASSERTED IN THE FINAL NEGOTIATION MAY STILL LEAD TO SOME CHANGES IN WHAT IS A FAIR AND REASONABLE PRICE, BUT THE RELATIVE POSITIONS ARE DEFINED FAIRLY WELL.

ONCE THE PCO ESTABLISHED THE PRICE NEGOTIATION OBJECTIVE, SOUND BUSINESS PRACTICE REQUIRES THAT THE CONTRACTING OFFICER OBTAIN APPROVAL OF THIS OBJECTIVE FROM MANAGEMENT. THIS STEP IS CONDUCTED SO THAT MANAGEMENT CAN BE ASSURED THAT THE CONTRACTING OFFICER HAS DONE A THOROUGH JOB OF SECURING AND EVALUATING COST OR PRICING DATA IN SUPPORT OF THE CONTRACTOR'S PROPOSAL AND IS ENTERING INTO NEGOTIATION WITH A WELL-CONCEIVED, REALISTIC AND FAIR PLAN.

THE NEGOTIATION OF CONTRACT PRICE USUALLY REQUIRES A DETAILED DISCUSSION WITH THE CONTRACTOR OF HIS PROPOSED COSTS ON AN ELEMENT-BY-ELEMENT BASIS (MATERIALS, LABOR, INDIRECT COSTS, ETC.). IT DOES NOT, HOWEVER, REQUIRE THAT THE CONTRACTING OFFICER OBTAIN AN AGREEMENT WITH THE CONTRACTOR ON AN ELEMENT-BY-ELEMENT BASIS. FOLLOWING THESE DETAILED DISCUSSIONS, IN MOST CASES, THE NEGOTIATIONS THEN CENTER AROUND THE REASONABLENESS OF THE TOTAL PRICE OF THE CONTRACT.

WHEN THE CONTRACT PRICE IS AGREED TO BY THE PARTIES, THE CONTRACTING OFFICER REQUIRES THE CONTRACTOR TO CERTIFY THAT THE COST OR PRICING DATA SUBMITTED ARE ACCURATE, COMPLETE AND CURRENT. THE CERTIFICATE OF CURRENT COST OR PRICING DATA SET FORTH IN DAR 3-807.6 IS USED FOR THIS CERTIFICATION. THE CERTIFICATE SIMPLY STATES, "THIS IS TO CERTIFY THAT, TO THE BEST

OF MY KNOWLEDGE AND BELIEF, COST OR PRICING DATA AS DEFINED IN DAR 3-807.1(a)(1) SUBMITTED, EITHER ACTUALLY OR BY SPECIFIC IDENTIFICATION IN WRITING TO THE CONTRACTING OFFICER OR HIS REPRESENTATIVE IN SUPPORT OF THE PROPOSAL (DESCRIBE THE PROPOSAL, QUOTATION, REQUEST FOR PRICE ADJUSTMENT OR OTHER SUBMISSION INVOLVED, GIVING APPROPRIATE IDENTIFYING NUMBER, E.G., RFP #XXX) ARE ACCURATE, COMPLETE, AND CURRENT AS OF THE DATE WHEN PRICE NEGOTIATIONS WERE CONCLUDED AND THE CONTRACT PRICE WAS AGREED TO. THIS CERTIFICATION INCLUDES THE COST OR PRICING DATA SUPPORTING ANY ADVANCE AGREEMENTS AND FORWARD PRICING RATE AGREEMENTS BETWEEN THE OFFEROR AND THE GOVERNMENT WHICH ARE A PART OF THE PROPOSAL." THE RESPONSIBILITY OF THE CONTRACTOR IS NOT LIMITED BY THE PERSONAL KNOWLEDGE OF THE CONTRACTOR'S NEGOTIATOR IF THE CONTRACTOR HAD INFORMATION REASONABLY AVAILABLE AT THE TIME OF AGREEMENT, SHOWING THAT THE NEGOTIATED PRICE WAS NOT BASED ON ACCURATE, COMPLETE AND CURRENT DATA. SINCE THE CERTIFICATE PERTAINS TO "COST OR PRICING DATA," IT DOES NOT MAKE REPRESENTATIONS AS TO THE ACCURACY OF THE CONTRACTOR'S JUDGMENT ON THE ESTIMATED PORTION OF FUTURE COSTS OR PROJECTIONS. IT DOES, HOWEVER, APPLY TO THE DATA UPON WHICH THE CONTRACTOR'S JUDGMENT IS BASED. THIS DISTINCTION BETWEEN FACT AND JUDGMENT SHOULD BE CLEARLY UNDERSTOOD. I MIGHT NOTE HERE THAT DOD DOES NOT CONSIDER A CERTIFICATE OF CURRENT COST OR PRICING DATA A SUBSTITUTE FOR EXAMINATION AND ANALYSIS OF THE CONTRACTOR'S

PROPOSAL. AS YOU WILL RECALL FROM MY EARLIER COMMENTS, OUR PROCEDURES REQUIRE THAT THE CONTRACTING OFFICER CONDUCT A COMPREHENSIVE REVIEW OF THE CONTRACTOR'S PRICE PROPOSAL AND THE SUPPORTING COST OR PRICING DATA.

AT THE CONCLUSION OF EACH NEGOTIATION OF AN INITIAL OR A REVISED PRICE, THE CONTRACTING OFFICER PREPARES A PRICE NEGOTIATION MEMORANDUM. THIS RECORD OF NEGOTIATIONS SETS FORTH THE PRINCIPAL ELEMENTS OF THE PRICE NEGOTIATION FOR INCLUSION IN THE CONTRACT FILE AND FOR THE USE OF ANY REVIEWING AUTHORITIES. THE MEMORANDUM IS PREPARED IN SUFFICIENT DETAIL TO REFLECT THE MOST SIGNIFICANT CONSIDERATIONS CONTROLLING THE ESTABLISHMENT OF THE CONTRACT PRICE. IT INCLUDES AN EXPLANATION OF WHY COST OR PRICING DATA WAS, OR WAS NOT, REQUIRED AND, IF IT WAS NOT REQUIRED, IN THE CASE OF A PRICE NEGOTIATION IN EXCESS OF $500,000, A STATEMENT OF THE BASIS FOR DETERMINING THAT SUCH DATA WAS NOT REQUIRED IS SET FORTH IN THE MEMORANDUM. IF COST OR PRICING DATA WAS SUBMITTED AND A CERTIFICATE OF COST OR PRICING DATA WAS REQUIRED, THE MEMORANDUM REFLECTS THE EXTENT TO WHICH RELIANCE WAS NOT PLACED UPON THE FACTUAL COST OR PRICING DATA SUBMITTED AND THE EXTENT TO WHICH THIS DATA WAS NOT USED BY THE CONTRACTING OFFICER IN DETERMINING HIS TOTAL PRICE OBJECTIVE AND IN NEGOTIATING THE FINAL PRICE. WHEN FIELD PRICING SUPPORT IS FURNISHED, THE CONTRACTING OFFICER FORWARDS COPIES OF THE MEMORANDUM TO THE COGNIZANT ACO AND AUDITOR.

UP TO THIS POINT MY COMMENTS HAVE BEEN DIRECTED TO THE REQUIREMENTS OF P.L. 87-653 AND HOW DOD HAS IMPLEMENTED THESE

REQUIREMENTS BEGINNING WITH THE ISSUANCE OF THE REQUEST FOR PROPOSAL AND CONTINUING THROUGH THE PROCUREMENT PROCESS UNTIL CONTRACT AWARD. THE NEXT PHASE THAT I WILL DISCUSS IS THE POST-AWARD PHASE WHICH INCLUDES THE GOVERNMENT'S REMEDY IN THE EVENT IT IS FOUND THAT COST OR PRICING DATA WAS NOT ACCURATE, COMPLETE AND CURRENT AS STIPULATED BY THE CERTIFICATE OF CURRENT COST OR PRICING DATA. IF CERTIFIED COST OR PRICING DATA ARE SUBSEQUENTLY FOUND TO HAVE BEEN INACCURATE, INCOMPLETE OR NONCURRENT AS OF THE EFFECTIVE DATE OF THE CERTIFICATE, THE GOVERNMENT IS ENTITLED TO AN ADJUSTMENT OF THE NEGOTIATED PRICE, INCLUDING PROFIT OR FEE, TO EXCLUDE ANY SIGNIFICANT SUM BY WHICH THE PRICE WAS INCREASED BECAUSE OF THE DEFECTIVE DATA. THE CLAUSES IN DAR 7-104.29, "PRICE REDUCTION FOR DEFECTIVE COST OR PRICING DATA" GIVE THE GOVERNMENT AN ENFORCEABLE CONTRACT RIGHT TO A PRICE ADJUSTMENT, THAT IS, TO A REDUCTION IN THE PRICE TO WHAT IT WOULD HAVE BEEN IF THE CONTRACTOR HAD SUBMITTED ACCURATE, COMPLETE AND CURRENT DATA. THE CLAUSES ALSO GIVE THE GOVERNMENT A RIGHT TO A PRICE ADJUSTMENT FOR DEFECTS IN COST OR PRICING DATA SUBMITTED BY A PROSPECTIVE OR ACTUAL SUBCONTRACTOR.

THE GOVERNMENT'S RIGHT TO REDUCE THE PRIME CONTRACT PRICE EXTENDS TO CASES WHEN THE PRIME CONTRACT PRICE WAS INCREASED SIGNIFICANTLY BECAUSE A SUBCONTRACTOR FURNISHED DEFECTIVE COST OR PRICING DATA. IF ANY SUCH SUBCONTRACTOR DATA ARE SUBSEQUENTLY FOUND TO BE DEFECTIVE, THE PRIME CONTRACT IS SUBJECT TO PRICE ADJUSTMENT IN THE SAME MANNER AS WOULD BE THE CASE IF ANY OTHER

COST OR PRICING DATA SUBMITTED BY THE PRIME CONTRACTOR PROVED TO BE DEFECTIVE.

A SIGNIFICANT FACTOR IN DOD'S IMPLEMENTATION OF THE ACT IS THE DOD POLICY THAT THE DEFENSE CONTRACT AUDIT AGENCY (DCAA) ESTABLISH AND CONDUCT A PROGRAM FOR REGULARLY PERFORMING SCHEDULED DEFECTIVE PRICING REVIEWS OF SELECTED CONTRACTS AND SUBCONTRACTS. I WILL NOT GO INTO DETAIL ON DCAA's AUDIT PROGRAM SINCE MR. STARRETT WILL COVER THIS ASPECT IN HIS REMARKS. AFTER DCAA PERFORMS A DEFECTIVE PRICING REVIEW OF A CONTRACT AND HAS REASON TO BELIEVE THAT DEFECTIVE DATA RESULTED IN A SIGNIFICANT INCREASE IN THE CONTRACT PRICE; THIS INFORMATION IS PROVIDED TO THE CONTRACTING OFFICER IN THE FORM OF AN OFFICIAL DCAA AUDIT REPORT.

THE NEXT STEP IN THE PROCESS IS FOR THE CONTRACTING OFFICER TO EVALUATE THE AUDIT REPORT TO DETERMINE IF THE GOVERNMENT IS LEGALLY ENTITLED TO A PRICE ADJUSTMENT.

IN ARRIVING AT A PRICE ADJUSTMENT, THE CONTRACTING OFFICER SHOULD, AFTER REVIEW OF THE RECORD OF THE CONTRACT NEGOTIATION, CONSIDER THE FOLLOWING:

1. THE TIME WHEN COST OR PRICING DATA WAS REASONABLY AVAILABLE TO THE CONTRACTOR. CERTAIN DATA SUCH AS OVERHEAD EXPENSES AND PRODUCTION RECORDS MAY NOT BE REASONABLY AVAILABLE EXCEPT ON NORMAL PERIODIC CLOSING DATES. ALSO, THE DATA ON NUMEROUS MINOR MATERIAL ITEMS EACH OF WHICH BY ITSELF WOULD BE INSIGNIFICANT MAY BE REASONABLY AVAILABLE ONLY AS OF A CUT-OFF

DATE PRIOR TO AGREEMENT ON PRICE BECAUSE OF THE VOLUME OF TRANSACTIONS WOULD MAKE THE USE OF ANY LATER DATA IMPRACTICABLE. FURTHERMORE, EXCEPT WHERE A SINGLE ITEM IS USED IN SUBSTANTIAL QUANTITY, THE NET EFFECT OF ANY CHANGES TO THE PRICES OF SUCH MINOR ITEMS WOULD LIKELY BE INSIGNIFICANT. CLOSING OR CUT-OFF DATES SHOULD BE INCLUDED AS A PART OF THE DATA SUBMITTED WITH THE CONTRACTOR'S PROPOSAL AND SHOULD BE UPDATED BY THE CONTRACTOR TO THE LATEST CLOSING OR CUT-OFF DATES, PRECEDING AGREEMENT ON PRICE, FOR WHICH SUCH DATA ARE AVAILABLE. THE CONTRACTING OFFICER AND CONTRACTOR ARE ENCOURAGED TO REACH A PRIOR UNDERSTANDING ON CRITERIA FOR ESTABLISHING CLOSING OR CUT-OFF DATES, AND TO THE EXTENT POSSIBLE, THE UNDERSTANDING SHOULD RELATE TO THE CONTRACTOR'S FORMAL ESTIMATING SYSTEM. NOTWITHSTANDING THE FOREGOING, SIGNIFICANT MATTERS ARE IMPORTANT TO CONTRACTOR MANAGEMENT AND TO THE GOVERNMENT AND ANY RELATED DATA WITHIN THE CONTRACTOR'S ORGANIZATION OR THE ORGANIZATION OF A SUBCONTRACTOR OR PROSPECTIVE SUBCONTRACTOR WOULD BE EXPECTED TO BE CURRENT ON THE DATE OF AGREEMENT ON PRICE AND, THEREFORE, WILL BE TREATED AS REASONABLY AVAILABLE AS OF THAT DATE. ALTHOUGH CHANGES IN THE LABOR BASE OR IN PRICES OF MAJOR MATERIAL ITEMS ARE GENERALLY SIGNIFICANT MATTERS, NO HARD AND FAST RULE CAN BE LAID DOWN SINCE WHAT IS SIGNIFICANT CAN DEPEND UPON SUCH CIRCUMSTANCES AS THE SIZE AND NATURE OF THE PROCUREMENT.

2. IN THE ABSENCE TO THE CONTRARY, THE NATURAL AND PROBABLE CONSEQUENCE OF DEFECTIVE DATA IS AN INCREASE IN THE CONTRACT

PRICE IN THE AMOUNT OF THE DEFECT PLUS RELATED BURDEN AND PROFIT OR FEE; THEREFORE, UNLESS THERE IS A CLEAR INDICATION THAT THE DEFECTIVE DATA WERE NOT USED, OR WERE NOT RELIED UPON, THE CONTRACT PRICE SHOULD BE REDUCED IN THAT AMOUNT. IN ESTABLISHING THAT THE DEFECTIVE DATA CAUSED AN INCREASE IN THE CONTRACT PRICE, THE CONTRACTING OFFICER IS NOT EXPECTED TO RECONSTRUCT THE NEGOTIATION BY SPECULATING AS TO WHAT WOULD HAVE BEEN THE MENTAL ATTITUDES OF THE NEGOTIATING PARTIES IF THE CORRECT DATA HAD BEEN SUBMITTED AT THE TIME OF AGREEMENT ON PRICE.

3. IN DETERMINING THE AMOUNT OF AN ADJUSTMENT, THE CONTRACTING OFFICER SHALL CONSIDER ANY UNDERSTATED COST OR PRICING DATA SUBMITTED IN SUPPORT OF PRICE NEGOTIATIONS FOR THE SAME PRICING ACTION (E.G., FOR THE INITIAL PRICING OF THE SAME CONTRACT OR FOR PRICING THE SAME CHANGE ORDER), UP TO THE AMOUNT OF THE GOVERNMENT'S CLAIM FOR OVERSTATED COST OR PRICING DATA ARISING OUT OF THE SAME PRICING ACTION. SUCH OFFSETS, HOWEVER, NEED NOT BE IN THE SAME COST GROUPINGS (E.G., MATERIAL, LABOR OR OVERHEAD).

4. THE CONTRACTING OFFICER SHALL ALSO COMPLY WITH THE REQUIREMENTS OF DOD DIRECTIVE 7640.2 IN RESOLVING DEFECTIVE PRICING AUDIT REPORTS (REFER TO THE COMMENTS UNDER "PROPOSAL EVALUATION EFFORT" OF THIS DOCUMENT FOR A MORE DETAILED DESCRIPTION OF THE REQUIREMENTS OF CONTRACT AUD FOLLOW-UP REGULATIONS).

SENATOR ROTH'S LETTER OF APRIL 4, 1983, STATED THERE WERE INDICATIONS THAT A RELATIVELY SMALL PERCENT OF THE TOTAL VALUE OF REPORTED DEFECTIVE PRICING IS BEING RECOVERED BY THE DEFENSE DEPARTMENT. WE HAVE BEEN ADVISED BY DCAA THAT THE RESULTS OF A STUDY CONDUCTED BY THEM BEGINNING WITH THEIR MANAGEMENT YEAR 1980 AND CONTINUING THROUGH THE FIRST HALF OF 1983, THAT CONTRACTING OFFICER'S HAD SUSTAINED 60 PERCENT OF THE AMOUNTS QUESTIONED BY THE DCAA AUDITORS.

FROM MY REMARKS HERE TODAY, ONE MIGHT CONCLUDE THAT THE ISSUE OF "DEFECTIVE PRICING" IS RELATIVELY SIMPLE. ON THE CONTRARY, IT IS A VERY COMPLEX SUBJECT. IT REQUIRES A COMPLETE ANALYSIS OF ALL OF THE FACTS OF A GIVEN SITUATION AND THE EXERCISE OF CAREFUL JUDGMENT AFTER CONSIDERATION OF THE FACTS. THEREFORE, MANY DEFECTIVE PRICING CASES REQUIRE THAT THE CONTRACTING OFFICER AVAIL HIMSELF OF ALL APPROPRIATE ORGANIZATIONAL TOOLS SUCH AS THE ADVICE OF SPECIALISTS IN THE FIELDS OF CONTRACTING, LAW, FINANCE, ENGINEERING, PRICE ANALYSIS, ETC., PRIOR TO ARRIVING AT A NEGOTIATION OBJECTIVE. WHILE THE DCAA AUDITOR IS AN IMPORTANT MEMBER OF THIS TEAM, THE AUDITOR CANNOT BE EXPECTED TO HAVE COMPLETE KNOWLEDGE IN ALL THE FIELDS OF OTHER SPECIALISTS. FOR EXAMPLE, THE AUDITOR MAY NOT HAVE ATTENDED THE NEGOTIATION CONFERENCE AND, AS A RESULT, MAY NOT HAVE BEEN AWARE OF ALL OF THE UPDATING OF THE COST OR PRICING DATA BY THE CONTRACTOR DURING THE COURSE OF NEGOTIATIONS. IN

SOME INSTANCES, AUDITORS ARE ABLE TO DEVELOP STRONG FACTUAL SUPPORT FOR DEFECTIVE PRICING ALLEGATIONS. ON THE OTHER HAND, THERE MAY BE STRONG INDICATIONS THAT DEFECTIVE PRICING OCCURRED, BUT LESS FACTUAL SUPPORT FOR THE POSITION.

WHEN THE CONTRACTING OFFICER CONCLUDES THAT DEFECTIVE PRICING EXISTS, A CONTRACT PRICE ADJUSTMENT IN THE AMOUNT BY WHICH THE DEFECTIVE DATA CAUSED AN INCREASE TO THE CONTRACT PRICE, IS REQUESTED OF THE CONTRACTOR. IF THIS IS NOT ACCEPTED BY THE CONTRACTOR AND THE CONTRACTOR FURNISHES ADDITIONAL INFORMATION THAT MAY NOT HAVE BEEN AVAILABLE TO THE CONTRACTING OFFICER IN REACHING HIS POSITION ON THE DEFECTIVE PRICING, THE CONTRACTING OFFICER WILL NORMALLY ATTEMPT TO NEGOTIATE A FAIR AND EQUITABLE SETTLEMENT WITH THE CONTRACTOR. AS IS THE CASE WITH MANY TYPES OF DISAGREEMENTS BETWEEN TWO PARTIES, THE UNDERLYING FACTS ARE NOT ALWAYS CLEARLY TO THE ADVANTAGE OF EITHER PARTY. IF THE PARTIES ARE UNABLE TO ARRIVE AT A MUTUALLY SATISFACTORY SETTLEMENT, THE CONTRACTING OFFICER WILL ISSUE A FINAL DECISION ON THE CASE. THE CONTRACTOR THEN HAS THE OPTION OF ACCEPTING THE FINAL DECISION OF THE CONTRACTING OFFICER'S STATED PRICE ADJUSTMENT OR MAY APPEAL THE DECISION TO THE ARMED SERVICES BOARD OF CONTRACT APPEALS OR FILE A SUIT AS PROVIDED BY THE CONTRACT DISPUTES ACT OF 1978 (P.L. 95-563). ISSUANCE OF A FINAL DECISION WITH THE POSSIBILITY OF SUBSEQUENT LITIGATION IS SOMETHING THAT IS NOT DONE IN DOD WITHOUT CAREFUL ANALYSIS AND JUDGMENT. WE

RELY VERY HEAVILY ON OUR LEGAL COUNSEL THROUGHOUT THIS ENTIRE PROCESS. OFTEN TIMES, COUNSEL ADVISES THE PCO THAT IT WOULD BE IN THE BEST INTERESTS OF THE GOVERNMENT TO NEGOTIATE A SETTLEMENT RATHER THAN TO LITIGATE THE ISSUE DUE TO THE FACTS AND CIRCUMSTANCES INVOLVED IN THE CASE.

ONCE THE DEFECTIVE PRICING CASE IS SETTLED, DAR 3-812 REQUIRES THE CONTRACTING OFFICER TO PREPARE A MEMORANDUM ON THE AUDIT REPORT INDICATING HOW THE ISSUE WAS RESOLVED. A COPY OF THE MEMORANDUM IS FORWARDED TO THE AUDITOR ISSUING THE AUDIT REPORT AND TO THE COGNIZANT ADMINISTRATIVE CONTRACTING OFFICER.

BEFORE I CONCLUDE MY COMMENTS, I WOULD LIKE TO BRIEFLY TOUCH ON THE ACTIVITIES OF THE ARMED SERVICES BOARD OF CONTRACT APPEALS (ASBCA). I WILL NOT GO INTO A LOT OF DETAILS BECAUSE I UNDERSTAND THE CHAIRMAN OF THE ASBCA WILL ALSO TESTIFY BEFORE THE COMMITTEE. TH BOARD ADJUDICATES CLAIMS RELATED TO CONTRACTS TO WHICH A MILITARY DEPARTMENT OR DEFENSE AGENCY IS A PARTY. THE BOARD, CONSTITUTED PURSUANT TO THE CONTRACT DISPUTES ACT OF 1978 OPERATES UNDER A CHARTER GRANTED JOINTLY BY THE SECRETARY OF DEFENSE, THE SECRETARY OF THE ARMY, THE SECRETARY OF THE NAVY, AND THE SECRETARY OF THE AIR FORCE. MEMBERS OF THE BOARD ARE ADMINISTRATIVE JUDGES WHO ARE CAREER CIVIL SERVANTS AND WHO ARE SELECTED FROM A REGISTER OF CANDIDATES FOR BOARDS OF CONTRACT APPEALS ON THE BASIS OF MERIT. THIS REGISTER SHALL CONSIST OF ATTORNEYS AT LAW WHO HAVE BEEN QUALIFIED IN THE MANNER PRESCRIBED

BY THE CONTRACT DISPUTES ACT OF 1978. NOMINATIONS OF CANDIDATES FOR THE ASBCA ARE MADE BY BOARD MEMBERS FROM THIS REGISTER. NOMINATIONS ARE SUBMITTED THROUGH THE DEPARTMENT OF DEFENSE GENERAL COUNSEL TO THE APPOINTING OFFICIALS. AUTHORITY FOR MAKING THESE APPOINTMENTS WITHIN OSD WAS DELEGATED BY THE BOARD'S CHARTER TO THE USDRE AND TO THE ASSISTANT SECRETARIES OF THE MILITARY DEPARTMENTS RESPONSIBLE FOR PROCUREMENT. UNDER THE CHARTER, THE CHAIRMAN AND VICE CHAIRMAN ARE APPOINTED OR REAPPOINTED FOR TWO-YEAR TERMS. REAPPOINTMENT IS CUSTOMARY. THE ASBCA CHARTER PROVIDES THAT THE BOARD SHALL HAVE ALL POWERS NECESSARY AND INCIDENT TO THE PROPER PERFORMANCE OF ITS DUTIES. THE BOARD ADOPTS ITS OWN METHODS OF PROCEDURE, AND RULES AND REGULATIONS FOR ITS CONDUCT AND FOR THE PREPARATION AND PRESENTATION OF APPEALS AND ISSUANCE OF OPINIONS. IT IS THE DUTY AND OBLIGATION OF THE MEMBERS OF THE ASBCA TO DECIDE APPEALS ON THE RECORD OF THE APPEAL TO THE BEST OF THEIR KNOWLEDGE AND ABILITY IN ACCORDANCE WITH APPLICABLE CONTRACT PROVISIONS AND IN ACCORDANCE WITH LAW AND REGULATIONS PERTINENT THERETO. IN MY OPINION, THIS IS BEING DONE. WE HAVE NOT IDENTIFIED ANY CHANGES TO DAR 3-807.10 THAT WERE PROMULGATED AS THE RESULT OF PRIOR ASBCA DECISIONS.

TO SUMMARIZE, WE BELIEVE THAT THE PURPOSE OF P.L. 87-653 TO BE TWOFOLD. FIRST, AND FOREMOST, TO PROVIDE CONTRACTING OFFICERS WITH COST OR PRICING DATA THAT IS AVAILABLE TO THE CONTRACTORS, THEREBY INCREASING THE ASSURANCE THAT FAIR AND REASONABLE

CONTRACT PRICES ARE NEGOTIATED AT THE OUTSET FOR GOODS AND SERVICES. SECONDLY, IN THE EVENT THAT DEFECTIVE COST OR PRICING DATA WAS SUBMITTED BY THE CONTRACTOR, THE ACT PROVIDES A REMEDY TO THE GOVERNMENT IN THE FORM OF A DOWNWARD CONTRACT PRICE ADJUSTMENT. WE BELIEVE THAT DOD HAS PROPERLY IMPLEMENTED P.L. 87-653 AND WE ARE CONSTANTLY ON THE ALERT OF WAYS IN WHICH TO IMPROVE POLICIES AND PROCEDURES WITH RESULTING SAVINGS IN THE AMOUNT OF DOLLARS EXPENDED FOR REQUIRED GOODS AND SERVICES.

AS A FINAL COMMENT, I WOULD JUST LIKE TO POINT OUT THAT IN FY 1982 DOD NEGOTIATED CONTRACTS VALUED AT ABOUT $39 BILLION THAT WERE SUBJECT TO P.L. 87-653. ALSO OF INTEREST IS THE FACT THAT THERE ARE OVERAGE DEFECTIVE PRICING AUDITS IN SOME PHASE OF SETTLEMENT TOTALING ABOUT $210 MILLION. WE READILY AGREE THAT THIS IS A SUBSTANTIAL SUM, BUT WHEN VIEWED AS A PERCENT OF OUR TOTAL BUSINESS THAT IS SUBJECT TO THE ACT, IT ONLY REPRESENTS ABOUT 1/2 OF 1 PERCENT OF THE TOTAL. FURTHER, WHEN YOU CONSIDER THAT WE RECOVER SOME PORTION OF THIS (60 PERCENT BASED ON A DCAA STUDY) IT FURTHER REDUCES THIS PERCENT. EVEN THOUGH THIS PERCENT OF DEFECTIVE PRICING IS RELATIVELY INSIGNIFICANT WHEN VIEWED AS A PART OF THE TOTAL, WE ARE NOT COMPLACENT IN OUR EFFORTS TO IMPROVE. WE EXPECT TO RESOLVE MANY OF THESE CASES DURING THIS FISCAL YEAR.

MR. CHAIRMAN, THIS CONCLUDES MY STATEMENT.

RESPONSES OF MR. GORDON TO QUESTIONS SUBMITTED BY SENATOR ROTH

DOLLARS SUSTAINED BY CONTRACTING OFFICERS

1a. QUESTION: If contracting officers are complying with DAR 3-812, why can't DCAA determine with some precision how many dollars of defective pricing reported by DCAA are sustained by contracting officers?

ANSWER: DAR 3-812 requires that the contracting officer prepare a memorandum on each audit report indicating the results of any contract action. A copy of this memorandum is required to be furnished to the auditor. DCAA has advised us that they have no problem in determining the cost questioned sustained by the contracting officer.

MEMORANDUM NOT RECEIVED BY AUDITOR

1b. Question: If DCAA does not receive the memorandum from the contracting officer as required by DAR 3-812 what action do you believe they should take?

ANSWER: The auditor could check with the local ACO and possibly obtain a copy. If not, the auditor should contact the PCO and request a copy. DCAA has advised us that they are receiving these memorandums.

PCO REFUSES TO PROVIDE COPY OF MEMORANDUM

1c. QUESTION: If all DCAA efforts to obtain a copy of the memorandum required by DAR 3-812 from the contracting officer are not successful, should DCAA report this situation to the head of the procurement office involved? If not, why not?

ANSWER: The audit office should escalate this problem to a level above the PCO. It may not be necessary or even desirable to go directly to the head of the procurement office unless this is a continuing problem. DCAA has advised us that they are receiving these memorandums.

MEMORANDUM NOT PROVIDED IN MANY CASES

1d. QUESTION: If there are a substantial number of instances where DCAA has been unable to obtain the memorandums required by DAR 3-812, has DCAA reported this situation to OUSDR&E? If not, why not?

ANSWER: Some problems have been experienced in this respect in the past. However, Department of Defense Directive No. 7640.2, (formally DoDI 5000.42 issued August 31, 1981) which contains policy for followup on contract audit reports, requires the contracting officer to prepare a memorandum covering the disposition of all audit reports. Also, the regulation requires the contracting officer to provide a copy of the memorandum to the cognizant contract audit. DCAA has advised that they are now receiving all of these required memorandums.

DEFECTIVE DATA IDENTIFIED BY DCAA

2a. QUESTION: If contracting officers are complying with DAR 3-812 and DCAA has determined from the required memorandum what defective data was recognized by the contracting officer should any defective data not identified in the memorandum and subsequently reported to the contracting offices by DCAA not be sustained?

ANSWER: To answer this question, it is necessary to briefly review the requirements of DAR 3-811, which states in part, "the contracting officer shall promptly prepare or cause to be prepared, a memorandum, setting forth the principal elements of the price negotiations...." Note that we require the PCO to address the principal elements. Contractors' cost proposals, in many cases, are extremely voluminous and it would not be practical to attempt to include all of the cost or pricing data in the memorandum. Also, in many cases, some of the data is specifically identified in the proposal rather than actually being submitted to the PCO. This is especially true in the case of a bill of materials. Some of these include thousands of parts and just would be impracticable to submit such data to the PCO. By identifying the data in the proposal, the auditor then has access to all such data during his review of the proposal. Therefore, it is often the case that the auditor identifies defective data for which the PCO may not have been aware of at the time of negotiations.

If such cost or pricing data are subsequently found to have been inaccurate, incomplete or noncurrent by DCAA as of the the effective date of the certificate, the Government is entitled to an adjustment of the negotiated price, including profit or fee, to exclude any significant sum by which the price was increased because of the defective data; provided, that the contracting officer relied upon such data in the negotiation of the contract price.

DEFECTIVE DATA NOT IDENTIFIED IN MEMORANDUM

2b. QUESTION: If DCAA submits a report to the contracting officer identifying defective data and the contracting officer does not sustain DCAA, because he says he was aware of the data, should that data have been identified in the memorandum required by DAR 3-811? If this data was not identified in the memorandum, what action, if any, should DCAA take?

ANSWER: The answer to the first part of the question is yes. DAR 3-811 states that the memorandum shall reflect the extent to which reliance was not placed upon the factual cost or pricing data submitted and the extent to which this data was not used by the contracting officer. The answer to the second part of the question is that no further action is required by DCAA.

COMPLIANCE WITH DAR 3-811

2c. QUESTION: If contracting officers are complying with DAR 3-811 and DCAA is using the information in the memorandum properly, should virtually all defective pricing violations reported by DCAA be sustained by the contracting officers?

ANSWER: To answer this question, it is necessary to briefly review the requirements of DAR 3-811 relating to the preparation of the memorandum. DAR 3-811 states in part, "the contracting officer shall promptly prepare or cause to be prepared, a memorandum, setting forth the principal elements of the price negotiations...." Note that we require the PCO to address the principal elements. Contractors' cost proposals, in many cases, are extremely voluminous and it would not be practical to attempt to include all of the cost or pricing data in the memorandum. Also, in many cases some of the data is specifically identified in the proposal rather than actually being submitted to the PCO. This is especially true in the case of a bill of materials. Therefore, even though the memorandum is helpful to the auditor, sole reliance cannot be placed upon it in the resolution of defective pricing cases.

REQUIREMENT TO PROVIDE MEMORANDUM TO DCAA

2d. QUESTION: Are contracting officers furnishing to DCAA copies of the memorandums required by DAR 3-811 in substantially all cases where they are required?

ANSWER: We have had some problems in this respect in the past. However, Department of Defense Directive No. 7640.2 (formerly DoDI 5000.42 issued August 31, 1981) which contains policy for followup on contract audit reports, requires the contracting officer to prepare a memorandum covering the disposition of all audit reports. A copy of this memorandum is required to be furnished to the contract auditor. Also, this regulation requires the contracting officer to notify the cognizant audit office in writing of cancellations of any acquisition action, and of any unsuccessful offerors not receiving award of a contract for which an audit report was issued. We have recently been advised by DCAA that they are now receiving substantially all of the price negotiation memorandums required by DAR 3-811.

IMPACT ON DCAA IF MEMORANDUM NOT PROVIDED

2e. QUESTION: If DCAA does not receive a copy of the memorandum required by DAR 3-811, how can it be expected to perform an effective review for defective pricing?

ANSWER: If the DCAA does not receive a copy of the memorandum it would limit the effectiveness of the DCAA review of that particular contract for defective pricing; however, we have been advised by DCAA that they are receiving substantially all of these memorandums.

MEMORANDUM NOT RECEIVED BY DCAA

2f. QUESTION: If DCAA does not receive the memorandum from the contracting officer required by DAR 3-811, what action do you believe they should take?

ANSWER: The auditor could check with the local ACO and possibly obtain a copy. If not, the auditor should contact the PCO and request a copy. DCAA advised us that they are now receiving substantially all of these memorandums.

PCO REFUSES TO PROVIDE DCAA COPY OF MEMORANDUM

2g. QUESTION: If DCAA efforts to obtain a copy of the memorandum required by DAR 3-811 from the contracting officer are unsuccessful should DCAA report this situation to the head of procurement office involved?

ANSWER: The audit office should escalate this problem to a level above the PCO. It may not be necessary or even desired to go directly to the head of the procurement office unless this is a continuing problem. DCAA advised us that they are now receiving subsantially all of these memorandums.

MEMORANDUM NOT PROVIDED IN MANY CASES

2h. QUESTION: If there are a substantial number of instances where DCAA has been unable to obtain the memorandums required by DAR 3-811, has DCAA reported this situation to DUSDR&E? If not, why not?

ANSWER: We have had some problems in this respect in the past. However, Department of Defense Directive No. 7640.2 (formerly DoDI 5000.42 issued August 31, 1981) which contains policy for followup on contract audit reports, requires the contracting officer to prepare a memorandum covering the disposition of all audit reports. A copy of this memorandum is required to be furnished to the contract auditor. Also, this regulation requires the contracting officer to notify the cognizant audit office in writing of cancellations of any acquisition action, and of any unsuccessful offerors not receiving award of a contract for which an audit report was issued. We have recently been advised by DCAA that they are now receiving substantially all of the price negotiation memorandums required by DAR 3-811.

AUDIT OF PROPOSALS UNDER $500,000

3a. QUESTION: Did the Deputy Secretary, Under Secretary of Defense for Research and Engineering or other initiators of Recommendation 10 of the "Carlucci initiatives" ask DCAA if they were auditing contractors' pricing proposals under $500,000? If so, who asked DCAA and what was DCAA'a response?

ANSWER: First, it is necessary to comment briefly on the April 30, 1981, Deputy Secretary of Defense report on "Improving the Acquisition Process." This document necessarily contained a very brief synopsis of each recommendation. The reference to audits of contracts of less than $500,000 pertained to defective pricing audits. This aspect was informally coordinated with DCAA. We believe that the recent DCAA response to this Committee, on the subject of defective pricing, confirmed that they have reviewed few, if any, contracts under $500,000 for defective pricing.

IF DCAA WAS NOT ASKED ABOUT AUDITS

3b. QUESTION: If DCAA was not asked about its audits of proposals under $500,000, did DCAA advise any of the initiators of Recommendation 10 whether DCAA was in fact auditing contractors' proposals under $500,000? If so how, when and to whom was this information communicated?

ANSWER: The reference in the report on "Improving the Acquisition" process referred to defective pricing audits of contracts under $500;000, not to audits of price proposals. Coordination on this subject was informal. However, the recent response to this Committee by DCAA confirmed that they have re~~ceiv~~viewed few, if any, contracts under $500,000 for defective pricing.

DCAA AUDITS OF PRICING PROPOSALS

3c. QUESTION: If DCAA was auditing contractors' pricing proposals under $500,000, about how many proposals were audited during 1981?

ANSWER: Based on data provided by DCAA, they audited 11,851 contractor pricing proposals that had values of less than $500,000 in their management year 1981. However, no defective pricing reviews of contracts of less than $500,000 were accomplished.

LEGISLATION TO LOWER THRESHOLD TO $100,000

3d. QUESTION: Would you support legislation to lower the threshold to $100,000?

ANSWER: DoD would not favor a move to reduce the threshold from the current level of $500,000 to $100,000 for several reasons. First, we proposed the increase from $100,000 to $500,000, in part, to account for the impact of inflation that has occurred in the national economy, since the inception of the "Truth-in-Negotiations" Act in 1962. Secondly, to ameliorate paperwork burdens on contractors and to permit more efficient use of DoD resources. Increasing the threshold to $500,000 has significantly reduced for the Government and its contractors the volume of paperwork incident to administering the requirements of the Act. The increased threshold, however, has not diminished the value of the Act because the total dollar value of DoD procurement subject to the Act has been reduced by a relatively insignificant amount.

IG ADVISE ON INCREASED THRESHOLD

3e. QUESTION: Did the Assistant to the Secretary of Defense (Review and Oversight), now the DoD IG advise you on this matter? If so, what was his advice?

ANSWER: The legislative proposal, DoD 97-92, to amend Title 10, United States Code, to increase the amount of the dollar threshold from $100,000 to $500,000 was officially submitted to the Office of Management and Budget on March 24, 1981. The Office of the Assistant to the Secretary of Defense (Review and Oversight) was not established at that time. It was established in April 1981.

DCAA VIEW ON FIELD PRICING THRESHOLD

4a. QUESTION: Did the Under Secretary of Defense for Research and Engineering who has responsibility for this policy, ask DCAA for its views on raising the audit report threshold requirement to $500,000 for all pricing proposals? If so, who asked DCAA and what was DCAA's response?

ANSWER: The basic policy for raising the field pricing threshold, as set forth in DAR 3-801.5(b), was developed by the DAR Pricing Subcommittee and approved by the DAR Council. DCAA has a representative on the DAR Pricing Subcommittee. DCAA did not favor raising the threshold to $500,000 for mandatory field pricing reports. They stated that maintaining the field pricing thresholds at their prior level would not risk loss of the prior savings realized. The views of DCAA were considered by the DAR Council in reaching the decision to increase the threshold for mandatory field pricing reports to $500,000.

DCAA VIEWS ON FIELD PRICING THRESHOLD

4b. QUESTION: Even though DCAA may not have been asked about raising the audit report threhold requirement to $500,000 for all pricing proposals, did DCAA advise the Under Secretary of Defense for Research and Engineering of its views on raising the threshold? If so, how, when and to whom was this information communicated?

ANSWER: Same response as to 4a., above.

NEGOTIATED REDUCTION ON PROPOSALS UNDER $500,000

4c. QUESTION: Did DCAA ever advise you as to how many dollars of hard cost savings resulted from the audit of (i) firm fixed price proposals under $500,000 and (ii) fixed price incentive proposals under $500,000? Also, did they advise you as to the ratio of cost saved to their cost of performance? If so, just what did DCAA tell you?

ANSWER: DCAA advised that on proposals audited by DCAA, Government savings on FFP proposals of less than $500,000 amounted to $125,756,000 and savings on other fixed price proposals amounted to $7,354,000 for DCAA's management year 1981.

DCAA also advised OSD as to the ratio of cost saved to their cost of performance. The "payback" as reflected by the DCAA study was 19 to 1 for FFP proposals and 14 to 1 for other than fixed price proposals. However, DCAA did not attribute the savings entirely to their audits. (Also see the response to question 4d.)

SAVINGS ON PROPOSALS UNDER $500,000

4.d. QUESTION: It is assumed that at the time you revised DAR 3-801.5(b)(1) and (2) you knew how many dollars were being saved by DCAA audits of proposals under $500,000. Didn't you consider those amounts ($170 million annually) significant enough to care about? If not, what amount would have to be saved before you would consider it to be significant enough to be concerned about?

ANSWER: Yes, we believe $170 million is significant. However, DCAA did not state that these savings resulted entirely from audits by DCAA. DCAA, in fact, stated that maintaining the field pricing thresholds at their prior level would not risk loss of the upwards of $140 million in DoD savings. We raised the threshold for mandatory field pricing reports to $500,000 on December 27, 1982. What we have done is simply to allow the contracting officer to exercise his judgment in whether or not a field pricing report is needed for procurements of less than $500,000. The DAR clearly states the responsibility of the contracting officer. DAR 3-801.2 states in part, "each contracting officer is responsible for performing or having performed all administrative actions necessary for effective contracting."

The assumption that without certified cost or pricing data and field pricing reports on procurements of under $500,000, that negotiated savings on individual proposals will no longer be realized is not valid. Contracting officers will still obtain audits and other field reviews in those cases where they believe it is necessary. In addition, they will utilize approved forward pricing rates for labor and overhead in determining the reasonableness of the proposed costs. Therefore, we do not anticipate any significant difference in the results of our negotiations of contracts under $500,000 as a result of the change in the threshold. We do, however, expect that the change will result in an improvement in the negotiated contract prices for those procurements exceeding $500,000 because more DCAA and plant representative resources are now available for evaluating and negotiating these larger dollar value procurements.

LOWERING THE FIELD PRICING THRESHOLD

4.e. QUESTION: Do you believe the savings attained in the past warrant lowering the threshold in DAR 3-801(b)(1) and (2) back to $100,000 for firm fixed-price proposals and $250,000 for fixed-price incentive proposals?

ANSWER: No

ADVICE OF ASSISTANT TO SECRETARY OF DEFENSE (REVIEW & OVERSIGHT)

4.f. QUESTION: Did you solicit the advice of the Assistant to the Secretary of Defense (Review & Oversight), now DoD IG about revising DAR 3-801.5(b)(1) and (2)? If not, did he independently provide advice? If so, what was his advice?

ANSWER: We did not solicit the advice of the Assistant to the Secretary of Defense (Review & Oversight) about revising the threshold in DAR 3-801.5(b)(1) and (2).

The Assistant to the Secretary of Defense (Review & Oversight) stated in his memorandum to USDRE dated January 4, 1982, that the results of the DCAA audits indicated that the Department would be remiss in arbitrarily raising the thresholds for required audits of fixed-price and fixed-price incentive proposals to $500,000. This was considered by the DAR Council in reaching their decision to increase the threshold for mandatory field pricing reports to $500,000.

The assumption that without certified cost or pricing data and field pricing reports on procurements of under $500,000, that negotiated savings on individual proposals will no longer be realized is not valid. Contracting officers will still obtain audits and other field reviews in those cases where they believe it is necessary. In addition, they will utilize approved forward pricing rates for labor and overhead in determining the reasonableness of the proposed costs. Therefore, we do not anticipate any significant difference in the results of our negotiations of contracts under $500,000 as a result of the change in the threshold. We do, however, expect that the change will result in an improvement in the negotiated contract prices for those procurements exceeding $500,000 because more DCAA and plant representative resources are now available for evaluating and negotiating these larger dollar value procurements.

PRESSURE TO DISCOURAGE DEFECTIVE PRICING AUDITS

5. QUESTION: It is understood that contractors from time-to-time put pressure on DCAA and the contracting officers to discourage them from conducting defective pricing audits. Are you aware of such activity and has this caused you any concern?

ANSWER: We are not aware of contractors putting pressure on DCAA and contracting officers to discourage them from conducting defective pricing audits. We would be concerned if such was the case.

SETTLING DEFECTIVE PRICING CASES

6. QUESTION: Statistics indicate that the Government generally settles defective pricing cases with contractors for only a small percent of the original findings reported by DCAA. Does this significant reduction occur because of defective work and reporting by DCAA, lack of aggressive action on the part of the contracting officers, the superior negotiating talents of the contractors, or what? What can be done to increase the percent of the defective pricing actually recovered from contractors?

ANSWER: We are not aware of the statistics that you refer to that shows the Government generally settles defective pricing cases with contractors for only a small percent of the original findings reported by DCAA. We do not maintain records showing the ratio of refunds obtained in relation to the total defective pricing questioned by DCAA audit reports. We were advised by DCAA that as a result of a study conducted by them, that contracting officers were sustaining about 60 percent of the amounts questioned by DCAA in their defective pricing audits.

There could be many reasons for the difference between the reported alleged defective pricing and price adjustments received pursuant to the Price Reduction for Defective Cost Pricing Data contract clause. This is a very complex subject and one that requires a complete analysis of all of the facts of a situation and the exercise of careful judgment after consideration of the facts. We now have guidance in DoD Directive 7640.2, "Policy for Follow-up on Contract Audit Reports" for tracking and reviewing settlements that should be adequate to insure that the settlements are fair and reasonable.

TIME-PERIOD TO SETTLE DEFECTIVE PRICING

7. QUESTION: Information furnished the Committee indicates that quite often it takes 5 or more years to settle a defective pricing case. What do you see as the primary cause for this extended settlement period?

ANSWER: This has been a problem in the past. However, with the emphasis now being placed on the resolution of audit reports by DoD, we expect to see a substantial improvement in the amount of time required to settle a defective pricing case. The DoD Directive 7640.2, "Policy for Follow-up on Contract Audit Reports" (formerly DoD Directive 5000.42 issued August 31, 1981) provides the necessary guidance and management visibility for the Military Service Secretaries to insure that adequate attention is devoted to resolving audit reports. Therefore, we expect that many of the open cases will be settled during this fiscal year.

STANDARDS FOR SETTLING DEFECTIVE PRICING CASES

8. QUESTION: What are your feelings on establishing mandatory time standards for purchasing offices to accomplish each major step in the settlement of reports on defective pricing?

ANSWER: We believe that establishing mandatory time standards for purchasing offices to accomplish each major step in the settlement of reports on defective pricing could have an adverse impact on the overall settlement. Too much pressure on the contracting officer to settle a case could diminish the effectiveness of the entire process and not be in the best interests of the Government. We believe the current program in place in DoD for audit follow-up, DoD Directive 7640.2, should adequately accomplish the desired goal of more timely settlements.

APPROVAL BY SERVICE SECRETARY

9. QUESTION: It is understood that many contracting officers will settle a defective pricing case for a few cents on the dollar rather than spend the time and effort to defend their position before the Armed Services Board of Contract Appeals. In an attempt to reduce the number of settlements for the sake of expediency, how would you feel about requiring the review and approval of all proposed defective pricing settlements for less than 25 percent of DCAA's original finding by the Service Secretary's office?

ANSWER: First, we have not seen any indications that contractng officers are simply settling defective pricing cases for a few cents on the dollar. Secondly, the contractng officer does not issue a final decision to reduce the contract price for defective pricing without the advice of the various specialists available to him. Often times, after all of the facts are available, the advice of counsel is to negotiate the best settlement possible because of the perceived weak position of the Government if the case is litigated.

We do not consider approval by the Service Secretary's office to be necessary. If the contracting officers negotiation objective is significantly different from the auditors recommendation, DoD Directive 7640.2 requires that the action be reviewed by a senior official above the level of the contracting officer. The contracting officer is then required to document in the memorandum of negotiations how the recommendation of the senior official was used. A copy of the memorandum is provided to both the senior official making the review and to the auditor. This provides an internal control feature to assure that audit recommendations are properly resolved.

PENALTIES ON ALL DEFECTIVE PRICING

10. QUESTION: Contractors currently have little incentive to furnish fully satisfactory cost data. To give them some incentive, how would you feel about assessing penalties on all defective pricing recoveries. In your response, please address the practicality of such a proposal, how much penalty you believe would be reasonable and how such penalty should be implemented, administratively or by statute?

ANSWER: We do not consider a monetary penalty to be desirable for defective pricing cases. In the event of fraud, there are adequate remedies already available. In other cases, once the contracting officer establishes a debt, interest accrues on that debt if not paid within 30 days.

Such a penalty would not be in the best interests of the Government. A monetary penalty, in all probability, would require agreement by the contractor that defective pricing did in fact occur. This would most likely drastically reduce the number of negotiated settlements and require that such cases be decided either by the ASBCA or the courts. In many cases, contractors are willing to negotiate a settlement but will not specifically agree that defective pricing did in fact exist. We, therefore, believe that if penalties are to be invoked, it would require a substantial increase in the litigation of defective pricing cases and the overall result would be less beneficial to the Government.

IMPACT OF LEGAL COSTS

11. QUESTION: To discourage contractors from appealing weak cases to the Armed Services Board of Contract Appeals, what are your feelings on prohibiting contractors from charging their legal fees to overhead on cases that are settled in the Government's favor?

ANSWER: First, we are not aware of a condition where contractors appeal weak cases to the ASBCA. The overall record of cases heard by the ASBCA does not appear to support this contention. Secondly, we already have a regulation (DAR 15-205.52) which disallows costs incurred in connection with the investigation, proceedings, or prosecution involving fraud on the part of the contractor, its agent or employee. Therefore, we do not believe that further regulations in this respect are needed at the present time.

SETTLING DEFECTIVE PRICING WITH OTHER ISSUES

12. QUESTION: It is understood that some contacting officers are settling defective pricing cases as part of other contract actions. How can the merits of the defective pricing case be fully explored and the interest of the Government fully protected if it is subordinated to other actions? Also, applying dollars recovered from a defective pricing action that probably took place years before would seem to have the effect of adding dollars to those appropriated for current procurements without the benefit of congressional action. Would you comment on this.

ANSWER: Our primary concern with regard to the settlement of defective pricing cases is whether or not the contracting officer obtained a fair and reasonable settlement. Whether the resolution is handled in conjunction with another negotiation or handled separately appears to be an administrative matter for which we should not be concerned. We do believe, however, that in either event, the records should clearly reveal what the contracting officer negotiated and the supporting rationale for such negotiations.

The DoD policy on handling refunds for defective pricing is as follows:

1. If a refund is received prior to final payment on the contract, it is preferable that the contract price be appropriately modified to reflect the refund. In such case, the

amount of the refund shall be credited to the applicable appropriation cited in the contract.

2. In cases where the refund is to be made by check rather than by an adjustment in the contract price, the check shall be made payable to the office designated for contract administration and shall be forwarded immediately to the Comptroller of the appropriate Department, or other Department Officer responsible for the control of funds. The check should be accompanied by a letter identifying the contract or contracts involved and the appropriation to which the refund should be credited. These funds could then be used to the extent the appropriation could still be used.

DECISIONS BY ARMED SERVICES BOARD OF CONTRACT APPEALS (ASBCA)

13. QUESTION: How do you feel about the decisions on defective pricing rendered by the Armed Services Board of Contract Appeals? Do you believe the Government gets a fair deal or do you believe the Board with its decisions has overstepped its bounds?

ANSWER: We believe that the ASBCA is properly discharging its duties and obligations, and that fair decisions are rendered by the Board.

CLAIMS FAIL DUE TO INADEQUATE DOCUMENTATION

14. QUESTION: It is understood that in numerous cases, defective pricing claims fail because contracting officers negotiated a "bottom line" price settlement and failed to specifically document the contract file as to the extent of the Government's reliance on the contractor's cost data. What are your thoughts on how this problem can be overcome?

ANSWER: Our regulations (DAR 3-811) covers the requirement to document the extent to which cost or pricing data was not relied upon. Our ongoing internal procurement reviews prior to contract award, training classes on contract pricing and negotiations, and reviews by other internal audit groups such as the DoD Inspector General should be adequate to insure that this requirement is properly adhered to.

MAKING POSTAWARD SETTLEMENTS MORE EFFECTIVE

15. QUESTION: In your opinion, what actions do you believe are necessary to make postaward audits and settlements under Public Law 87-653 more effective?

ANSWER: We believe that the emphasis and visibility now afforded by the procedures in DoD Directive 7640.2, "Policy for Follow-up on Contract Audit Reports" are adequate to insure that defective pricing settlements are fair and reasonable. Therefore, we do not believe that further changes in DoD policy and procedures are needed at the present time.

DEFECTIVE PRICING CLAUSE AND CERTIFICATE

16. QUESTION: It is understood that there are cases when contracts subject to Public Law 87-653 have been awarded without defective pricing clauses and without the contracting officer obtaining the required data certificate. Please tell us how often this happens, why it happens, what, if any, other remedies are available as a substitute, and what can be done to ensure that required clauses and certificates are included in and obtained for all future contracts.

ANSWER: Our regulations clearly provide that when the procurement is subject to P.L. 87-653 that the defective pricing clause be included in the contract and that the contracting officer obtains the required certificate of current cost or pricing data. We are not aware of any recent instances where this has not been accomplished. With the internal reviews that we have prior to contract award, there should not be any cases where these requirements are overlooked.

AGRESSIVE SETTLEMENT OF DEFECTIVE PRICING

17. QUESTION: It is understood that there is a feeling that some contracting officers do not aggressively pursue the settlement of DCAA's defective pricing reports or dismiss them because they feel such reports are a reflection on their efforts in negotiating a reasonable price. To overcome such self interest, how would you feel about assigning DCAA's defective pricing reports for settlement to a contracting officer that was not involved in the original contract negotiations as is done in the case of contract terminations?

ANSWER: In our opinion, contracting officers do not simply dismiss the defective pricing reports because they feel such reports are a reflection on their efforts in negotiating a reasonable price. DoD Directive 7640.2, "Policy for Follow-up on Contract Audit Reports" provides a system for tracking audit reports and for the review of differences on the resolution of audit recommendations by senior officials at a level above the contracting officer. With respect to assigning the defective pricing case to another contracting officer, in our opinion, would be counterproductive since the contracting officer that negotiated the contract is in the best position to follow through with an effective analysis and disposition of the defective pricing audit.

INTEREST CHARGES ON DEFECTIVE PRICING

18. QUESTION: It is understood that interest charges on defective pricing recoveries doesn't begin until the contracting officer issues a final decision on reported defective pricing. Doesn't this encourage a contractor to delay providing information needed by the contracting officer to reach a decision as long as possible, thus obtaining interest free use of Government money for longer periods. Why shouldn't interest be assessed from the date the defective data was certified? What becomes of the money refunded by contractors in settlement of defective pricing claims? Is it returned to the Treasury or can Defense use it for other programs?

ANSWER: Once the contracting officer establishes a debt, interest accrues on that debt if not paid within 30 days. If the contractor unduly delays in responding to the contracting officers requests for information, the contracting officer has the remedy of issuing his final decision. Interest would then begin to accrue at that point. With respect to money refunded, checks are forwarded immediately to the Comptroller of the appropriate Department. Funds could be used to the extent the appropriation to which it applied could still be used.

TIMELINESS OF SETTLEMENTS

19. QUESTION: The timeliness of settlements of defective pricing cases has been a problem over the years. The contract audit follow-up status report for the six month period ended September 30, 1982, submitted to the DoD IG in accordance with DoD Directive 5000.42 (now 7640.2) identifies 145 defective pricing cases with a value of $210 million on contracts awarded to 45 separate contractors where contracting officers are experiencing

problems in disposing of pricing reports on a timely basis. It indicates 32 cases outstanding for Grumman and 26 cases outstanding for McDonnell Aircraft. Are you satisfied with the timeliness of settlement of these cases? If not, what ar you doing about it?

ANSWER: Some defective pricing cases are very complex and difficult to settle. Timely settlements have been a problem. We are satified that every reasonable effort, within the resources available and considering other priorities, is currently being made to settle these cases in a manner that will be fair and reasonable. Naturally, we would like to clear up all open defective pricing cases. However, if too much pressure is applied, the results could be unfavorable. On August 13, 1982, the Secretary of Defense sent a letter to the Secretaries of the Military Deartments and to the Director, Defense Logistics Agency in which he emphasized his concern in this area. We expect that the next report for the six month period ended April 1, 1983, will show more cases being closed.

UNDER SECRETARY OF DEFENSE RESEARCH AND ENGINEERING ROLE IN THE ARMED SERVICES BOARD OF CONTRACT APPEALS

20.a. QUESTION: Who establishes the general policies under which the ASBCA operates?

20. a. ANSWER: The Board operates under general policies established or approved by the Under Secretary of Defense (Research and Engineering).

20.b. QUESTION: Who appoints the ASBCA members?

20.b. ANSWER: The ASBCA members are appointed by the Under Secretary of Defense (Research and Engineering) and the Assistant Secretaries of the Military Departments responsible for procurement.

20.c. QUESTION: Who has the authority to remove a member of the ASBCA before the completion of the full term?

20.c. ANSWER: Board members could be removed by the appointing authorities if it ever became necessary to do so.

Statement of

Mr. Charles O. Starrett, Jr.

Director, Defense Contract Audit Agency

before the

United States Senate

Committee on Governmental Affairs

on

Department of Defense Implementation

of Public Law 87-653

Thursday, 14 April 1983

Not For Publication Until Released By The Committee

Mr. Chairman, it is a pleasure for me to appear before this committee to discuss the Department of Defense's implementation of Public Law 87-653, otherwise known as the "Truth-In-Negotiations" Act.

DCAA is an independent audit organization that furnishes auditing and financial advisory services to the acquisition community. That is, we play an active part in the procurement process. Our entire activity is subject to outside scrutiny by the Defense Audit Services, other segments of the DoD IG organization, the General Accounting Office, and various special review and study teams, not to mention our own internal peer review activities.

We are trained and experienced in auditing the accounting systems and financial representations of commercial organizations--not those of Government organizations.

With regard to Public Law 87-653 concerning Truth-In-Negotiations, I would like to briefly discuss my view of the primary problem that law was intended to resolve, the method required by the law for solving the problem and the efforts of the Defense Contract Audit Agency to assure contractor compliance with the law.

A primary problem within the Government's procurement process in the late 1950's was how to assure reasonableness of prices for items procured where there is neither adequate price competition nor the safeguards which normally flow from economic forces at work in a competitive market. This was the situation when, in May 1959, the General Accounting Office reported to Congress that its 12 month examination of Department of Defense contracts disclosed several instances in which contractors received higher prices and realized greater profits than they would have, had Government personnel been provided all of the cost or pricing data that was available to the contractors during negotiation of the contract prices.

The Department of Defense reacted promptly to the reported findings of the General Accounting Office by publishing on 1 October 1959, a revised section of the Armed Service Procurement Regulation (now called the Defense Acquisition Regulation). Among other things, the revision required applicable contractors to provide the Government negotiator with a Certificate of Current Pricing Data. At the end of January 1961, another change to the Armed Services Procurement Regulation required downward adjustments of contract price when the price is based on inaccurate, noncurrent, or incomplete cost or pricing data.

Congress, however, further strengthened the procurement regulations when on 10 September 1962, it enacted Public Law 87-653. The Act requires Government contractors to fully disclose their cost or pricing data to Government negotiators and to certify that such information is current, complete and accurate at the time of agreement on price. The Act also requires that contracts provide for a downward adjustment in contract price if the negotiated price is greater than it should have been because the contractor furnished inaccurate, incomplete or noncurrent pricing data to the Government.

All of the above actions occurred between 1957 and 1962, the latter date being approximately 3 years prior to the establishment of the Defense Contract Audit Agency. The Defense Contract Audit Agency was created in June 1965 to perform all necessary contract audit work for the Department of Defense and provide accounting and financial advisory services regarding contracts and subcontracts to all Department of Defense components responsible for procurement and contract administration. These services are provided in connection with the negotiation, administration and settlement of contracts and subcontracts.

Five months after the Defense Contract Audit Agency had been established, the Department of Defense responded to a GAO report entitled Need For Postaward Audits To Detect Lack Of Disclosure Of Significant Cost Or Pricing Data Available Prior To Contract Negotiation And Award by giving the Defense Contract Audit Agency the responsibility for performing postaward reviews of covered contracts for defective pricing. The Defense Contract Audit Agency immediately undertook a three-pronged approach to ensure contractor compliance with the Law; namely, special emphasis on surveys to determine the adequacy of contractor estimating systems, stronger efforts to obtain adequate data during preaward audit reviews, and performance of postaward defective pricing compliance reviews. This comprehensive approach is still used as the cornerstone for the Agency's guidance to our field auditors on defective pricing.

Our guidance on defective pricing is premised on the belief that it is more advantageous to the procurement community as a whole to correct estimating deficiencies causing defective pricing before they occur instead of performing compliance reviews to detect defective pricing after the contract prices have been established. Deficiencies in cost estimates can arise from the contractor's use of incorrect, incomplete, or noncurrent data. Accordingly, we spend a significant amount of effort in our estimating system surveys and preaward audits to prevent the occurrence of such deficiencies.

Estimating system surveys represent a joint contract audit and contract administration team effort under the leadership of the auditor for the comprehensive review of a contractor's organization, policies, procedures and practices used to prepare cost estimates and price proposals. The surveys are intended to ascertain the general level of reliability of contractor estimates, identify areas of weakness that may require special emphasis during the review and negotiation of individual pricing proposals, and to recommend improvements necessary to effect corrective action.

Copies of the estimating system survey report are furnished to each purchasing and contract administration office having substantial business with the specific contractor. These reports then become subject to the tracking and reporting requirements of Department of Defense Directive Number 7640.2, "Policy For Followup On Contract Audit Reports". Over the last 2 1/2 years, we have expended 52,000 direct audit hours on this effort and issued approximately 410 survey reports.

A second way in which the Defense Contract Audit Agency attempts to identify deficient estimating techniques causing defective pricing occurs as an integral part of the Agency's program to review and evaluate estimated costs in proposals submitted by contractors in connection with the award, administration, modification or repricing of Government contracts.

The evaluation of contractor pricing actions is the Agency's highest priority program. Last year alone, the Defense Contract Audit Agency expended 1,800,000 direct audit hours to review 27,200 bid proposals. Of necessity, some portion of these hours were incurred to determine whether the contractor's estimating techniques used to develop specific bid proposals are both consistent with established policies, procedures and practices, and appropriate for the proposal under review. Without this determination, the Agency could not satisfy its mission to render an overall opinion on the reasonableness of proposed contract costs. Significant or recurring estimating deficiencies disclosed during proposal reviews are reported to purchasing and contract administration offices in a separate audit report.

While we can quantify the specific findings identified during our reviews and surveys, we also believe that our activities have deterred significant amounts of contract overpricing caused by defective data which we are unable to quantify. I believe that the consistent and continuing application of sound estimating techniques and the development of reliable systems to assure complete and current supporting documentation by contractors is essential to the deterrence of excessive pricing resulting from defective data.

The third part of our program to combat defective pricing concerns the performance of Public Law 87-653 postaward compliance reviews. From its inception the Agency's compliance program has been accorded a high priority, second only to the review and evaluation of pricing proposals. The primary objectives of our defective pricing compliance reviews are:

(i) to ascertain whether individual contractors are in compliance with Public Law 87-653 as it relates to specific pricing actions,

(ii) to recommend contract price adjustments necessary for Government recovery of contract overpricing caused by defective pricing, and

(iii) to recommend actions to correct deficient contractor estimating procedures.

Many Department of Defense contractors have literally thousands of contracts subject to the provisions of Public Law 87-653. The Defense Contract Audit Agency is unable to audit all of these contracts for compliance with Public Law 87-653 because of resource limitations and other audit responsibilities.

It is important, therefore, to consider the amount of Government savings resulting from efforts expended on individual Agency programs. For example, last years' forward pricing program had a Government savings to Agency cost ratio of 132:1 versus a savings to cost ratio for the defective pricing compliance program of approximately 19:1. Obviously, we have to balance our application of resources recognizing these returns. In addition, the performance of our defective pricing program requires a determination of the universe of contracts subject to Public Law 87-653 and then a determination of contracts most susceptible to potential defective pricing.

In the 15 years in which the Defense Contract Audit Agency has performed defective pricing compliance reviews, we have expended many thousands of direct audit hours to complete 19,000 reviews resulting in total recommended price adjustments of $1.1 billion. In the same 15 year period, we have developed and implemented an early warning system for the detection of apparent defective pricing, a matrix of contract pricing actions for contract selection purposes, and a detailed audit program that provides guidance for the efficient and effective accomplishment of defective pricing compliance reviews. Refinements are, of course, continually being made to our program as they are to all of our programs.

We believe that the Defense Contract Audit Agency's defective pricing compliance program successfully achieves the intent of Public Law 87-653, as interpreted by the Armed Services Board of Contract Appeals and the Court of Claims. This opinion is based on the fact that 28 separate reviews performed by the General Accounting Office and other internal audit organizations have not disclosed any significant weaknesses in our program to assure contractor compliance to

Public Law 87-653. I want to assure you that I intend to maintain the effective audit coverage of this important area, and we would be pleased to assist the Committee in any way we can as the various aspects of Public Law 87-653 are considered.

I want to express my appreciation for the opportunity to appear before this committee, and now I will try to answer your questions.

DEFENSE CONTRACT AUDIT AGENCY
CAMERON STATION
ALEXANDRIA, VIRGINIA 22314

IN REPLY REFER TO

OTD
225.5.1

Honorable William V. Roth, Jr.
Chairman, Senate Committee on Governmental Affairs
Senate Hart Building 104
Washington, D.C. 20510

Dear Chairman Roth:

By letter dated 30 March 1983, you requested written responses to several prehearing questions on DCAA's defective pricing compliance review program. The requested information is provided as an enclosure to this letter.

Contractor information contained in some of our answers may be confidential. The restrictions of 18 USC 1905 should be considered before this information is released to the public.

Sincerely,

C. O. STARRETT, Jr.
Director

Encl

Prehearing Questions and Answers
Senate Committee on Governmental Affairs
14 April 1983

Question No. 1

The Under Secretary of Defense on Research and Engineering by letter dated March 11, 1983 stated that "we were advised by DCAA that as a result of a study conducted by them in 1982, contracting officers were sustaining about 46 percent of the amounts questioned by DCAA in their defective pricing audits, but "this information was qualified to the extent that DCAA was receiving complete feedback from contracting officers in this regard." In this connection answer the following questions:

a. How many defective pricing reports and related settlements were included in the study and what period of time was covered? What was the total dollars of defective pricing reported by DCAA and what was the total dollars sustained?

Response: The study referred to by the Under Secretary of Defense for Research and Engineering concerned defective pricing compliance reviews settled by procurement during our management year 1982. This surveillance effort did not attempt to determine how specific findings were disposed of but did result in obtaining an overall sustention percentage. Statistics requested are as follows:

Number of audit assignments included in the study.	143
Total Recommended Price Adjustment	$49,538,000
Negotiated Price Adjustment	$22,833,000
Sustention Percentage	46%

b. On what percentage of defective pricing reports does DCAA get feedback (DAR 3-812) from contracting offficers? (Give an estimate if actual percentage is not available.)

Response: Practically speaking we eventually obtain contracting officer feedback on almost all of our defective pricing reports. It is the time delay aspect of the final settlement action that makes our internal system unsuitable for tracking and monitoring audit reports on a current basis.

In this regard, our auditors may be unaware of the current status of an audit finding because of those situations where the contracting officer issues a final decision only to have the contractor subsequently appeal that action. Thus, our MIS may reflect the contracting officer's final decision, but it may not reflect the subsequent fact that it has become a board of contract appeals case.

c. If DCAA does not know the answer to b. above can the 46 percent figure be used as a good indicator of the extent of total dollars reported by DCAA that are sustained by contracting officers?

Response: As I mentioned before, the study that determined a 46 percent sustention factor on alleged defective pricing was limited to management year 1982 actions. Since the time that the Under Secretary of Defense for Research and Engineering requested a DCAA estimate of the sustention percentage, we have made a detailed analysis of contracting officer settlements for management years 1980 through the first half of 1983. This analysis, summarized below, shows that the 46 percent rate is not a very good indicator of overall program results.

	Rate of Sustention
MY 1980 (9 Months)	52%
MY 1981	66%
MY 1982	46%
MY 1983 (1st Half)	74%
Overall Percentage for Last 39 Months	60%

Question No. 2

DAR 3-812 states that the contracting officer shall prepare and submit to DCAA on each defective pricing report received a memorandum indicating (1) whether defective data were submitted and relied upon and (2) the results of any contract action taken. In this regard answer the following questions:

a. If contracting officers are complying with DAR 3-812, why can't DCAA determine with some precision how many dollars of defective pricing reported by DCAA are sustained by contracting officers?

Response: DCAA can determine with reasonable accuracy the final disposition of defective pricing findings for audits when we obtain the DAR 3-812 report.

b. If DCAA does not receive the memorandums from the contracting officers as required by DAR 3-812, what action does DCAA take?

Response: As I stated in a previous response DCAA does eventually receive the majority of the contracting officers' notice of final settlement. However, in those cases where a reasonable time has passed and the auditor has no knowledge of the contracting officer's action, the first and usually the second inquiry, if necessary, is made to the report addressee. If this effort is unsuccessful the auditor will ask for the assistance of the procurement liaison auditor having cognizance of the contracting officer.

c. If all DCAA efforts to obtain a copy of the memorandum required by DAR 3-812 are not successful does DCAA report this situation to the head of the procurement office involved? If not, why not?

Response: If a particular office seems to be igorning this DAR provision we would discuss it with the head of the office.

d. If there are a substantial number of instances where DCAA has been unable to obtain the memoranda required by DAR 3-812, has DCAA reported this situation to OASD(C) and OUSDR&E? If not, why not?

Response: DCAA does not have a significant problem in obtaining final settlement actions, as explained above, and the data we do obtain is satisfactory for the management of our audits. Therefore, no reports have been made to either OASD(C) or OUSDR&E.

Question No. 3

DAR 3-811 requires the contracting officer to prepare a procurement negotiation memorandum (an the negotiation of an initial or revised price). If cost or pricing data was submitted and a certificate of cost or pricing data was required, the memorandum shall reflect the extent to which reliance was not placed upon the factual cost or pricing data submitted and the extent to which this data was not used by the contracting officer in determining his total price objective and in negotiating the final price. The memorandum shall also reflect the extent to which the contracting officer recognized in the negotiation that any cost or pricing data submitted by the contractor was inaccurate, incomplete, or noncurrent; the action taken by the contracting officer and the contractor as a result; and the effect, if any, of such data on the total price negotiated. It also, provides that a copy of the memorandum shall be forwarded to DCAA. In this regard answer the following questions?

a. If contracting officers are complying with DAR 3-811 and DCAA has determined from the required memorandum what defective data was recognized by the contracting officer, should any defective data not identified in the memorandum and subsequently reported to the contracting officer by DCAA be sustained?

Response: I agree that when a price negotiation memorandum presents in a clear and concise manner all of the cost or pricing data relied on by the Government negotiator, then defective data not identified in the memorandum should be reported and sustained as defective pricing. However, we must be practical; for a contracting officer to detail all cost or pricing data relied on to negotiate the hundreds or thousands of proposed material parts, labor rates and indirect expenses would necessitate a document of gigantic proportion.

Because the contracting officer chooses to, or of necessity must summarize rather than detail, cost or pricing data relied on in negotiations, we may not be able to determine with certainty whether data not identified in the negotiation memorandum would result in defective pricing.

b. If DCAA submits a report to the contracting officer identifying defective data and the contracting officer does not sustain DCAA, because he says he was aware of the data, should that data have been identified in the memorandum required by DAR 3-811? If this data was not identified in the memorandum what action, if any, does DCAA take?

Response: As I just stated, it is difficult, and in some large procurements virtually impossible, for a contracting officer to identify all of the contractor's cost or pricing data relied on by the Government negotiator. Certainly, DCAA would prefer a complete and detailed negotiation memoranda. In the absence of complete disclosure of cost or pricing data relied on by the Government, DCAA uses the contractor's proposal as the base line for performance of defective pricing compliance reviews.

c. If contracting officers are complying with DAR 3-811 and DCAA is using the information in the memorandum properly, should virtually all defective pricing violations reported by DCAA be sustained by the contracting officers?

Response: Assuming everything occurs as stated in your question and the contractor does not propose setoff amounts, all defective pricing violations should be sustained.

d. Does DCAA receive copies of the memorandums required by DAR 3-811 in substantially all cases where they are required?

Response: To the best of my knowledge, the majority of price negotiation memorandums are received by DCAA.

e. If DCAA does not receive a copy of the memorandum required by DAR 3-811 how can it perform an effective review for defective pricing?

> Response: We certainly perfer receiving a price negotiation memorandum, as it represents the normal starting point for the defective pricing compliance audit. This philosophy is embodied in our guidance which states that the auditor should obtain and review the negotiation memorandum before initiating a defective pricing compliance review. However, we may still review a pricing action without the memoranda, particularly if we have an indication of defective pricing.

f. If DCAA does not receive the memorandum from the contracting officer what action does DCAA take?

> Response: DCAA internal followup procedures requires the cognizant field audit office to request in writing, a copy of the contracting officer's DAR 3-812 memorandum. In those situations in which the local audit office is unable to determine final disposition of an audit finding, DCAA's procurement liaison auditors (PLAs) initiate on-the-spot followup capacity to major procurement and contract administration offices.

g. If DCAA's efforts to obtain a copy of the memorandum required by DAR 3-811 from the contracting officer are unsuccessful, does DCAA report this situation to the head of the procurement office involved?

> Response: If necessary; however, we communicate regularly with top level procurement officials in DoD and they have emphasized several times the importance of furnishing PNMs to our auditors.

h. If there are a substantial number of instances where DCAA has been unable to obtain the memoranda required by DAR 3-811, has DCAA reported this situation to OASD(C) and OUSDR&E? If not, why not?

> Response: Please refer to our response to question 2d.

Question No. 4

In response to our request for a listing of the 10 contractors with the poorest records of PL 87-653 compliance during the past 5 years DCAA provided a list of 6 contractors (numbers 1 through 6 below). DCAA also, provided defective pricing statistics for MY 1981, MY 1982, and the first half of MY 1983 for each branch and resident audit office. Data for the 6 contractors identified by DCAA as well as for 11 additional contractors for which DCAA statistics indicate a poor history of PL 87-653 compliance are shown below.

Contractor	Number of Positive Reviews	Recommended Amount of Price Adjustment	Audit Hours Expended
1. AVCO Aerostructures	--------------(see note 1)----------------		
2. Gould Inc., Ocean Systems	1	$ 377,000	752
3. Emerson Electric	--------------(see note 2)----------------		
4. Lima Tank Plant	0	0	234
5. General Dynamics Systems, Inc.	5	3,833,000	1,542
6. McDonnell Aircraft	28	48,652,000	8,267
7. Grumman Aerospace Corp.	40	24,469,000	13,122
8. Texas Instruments, Inc.	22	5,193,000	6,765
9. GE Schenectady	12	4,998,000	3,113
10. UTC Pratt & Whitney	6	55,004,000	9,904
11. Raytheon Co. Equipment Division	18	2,163,000	8,568
12. Northrop Corp.	9	6,896,000	6,506
13. Newport News Ship & Dry Dock	5	21,938,000	3,157
14. Westinghouse Electric	11	7,152,000	7,316
15. Boeing Seattle	9	28,726,000	9,441
16. Martin Marietta Aero. (Denver)	11	7,097,000	5,000
17. Sanders Associates	8	1,725,000	3,021

Note 1. AVCO Aerostructures, Nashville, Tennessee is a suboffice of the Huntsville Branch. The Huntsville Branch shows a total of 2 positive reviews with a dollar value of $71,000. These 2 reviews may be AVCO or they may be some other company.

Note 2. Emerson Electric, St. Louis, Missouri is a suboffice of the St. Louis Branch. The St. Louis Branch shows a total of 6 positive reviews with a dollar value of $6,199,000. These 6 reviews may be Emerson Electric or they may be some other company.

a. Contractors 1 through 6 (category 3 type contractors), above, were identified by DCAA as the contractors with the poorest records of PL 87-653 compliance. DCAA statistics indicate that (i) AVCO may have had a maximum of 2 findings valued at $71,000, (ii) Gould had 1 finding valued at $377,000, and (iii) Lima Tank Plant did not have any findings. Also, only 752 hours of audit were expended at Gould during the past 2 1/2 years and 234 hours of audit were expended at the Lima Tank Plant. These statistics do not appear to indicate serious problems. Please explain why you indicated them to be problem contractors, and if they are problem contractors why so little audit effort is being expended on them?

Response: DCAA uses several techniques to identify contractors having insufficient controls for the prevention of defective pricing. The categorization process that you mentioned is but one of those techniques that uses the results of interrelated audits to identify contractors for further audit followup of estimating practices. The categorization process represents an internal method for the planning of several different audits designed to correct the deficiencies and determine the impact, if any. A contractor with a 3 rating means that the cognizant audit office plans an increased level of effort to perform estimating system reviews, defective pricing compliance audits, and other evaluations. An example of the technique's usefulness with AVCO Aerostructures is as follows.

In the latter part of 1982, the DCAA office cognizant of AVCO Aerostructures discovered several estimating system deficiencies that seriously impaired the usefulness of contractor estimates for negotiation purposes. The audit office has used the categorization process to assign a high priority for the accomplishment of a comprehensive estimating system review and several defective pricing audits. All of these reviews are planned for completion within the next 6 months. In the event that the contractor takes the necessary corrective action, the rating will be reevaluated.

All of the other category 3 contractors have similar reasons for their rating.

b. Contractors 7 through 17 were not identified by DCAA as contractors with poor records of PL 87-653 compliance; yet, DCAA statistics for the last 2 1/2 years indicate that they should have been. These 11 contractors have numerous instances of defective pricing valued in the millions of dollars. Also, a sustantial number of hours of audit effort have been expended on them. Please explain why you do not consider these contractors to have poor records of compliance with PL 87-653 and did not identify them as such to us.

Response: We are well aware of the estimating problems at these contractors and believe that the results of our defective pricing compliance reviews indicates that the proper level of resources is assigned to the identification of contract overpricing. However, we are reevaluating the classifications of these contractors.

c. We understand that DCAA classifies contractors based on audit experience at Category 1--least likely to have defective pricing, Category 2--moderately likely, and Category 3--most likely. Please explain why DCAA's system of categorizing contractors resulted in classifying contractors 1, 2 and 4 as Category 3 and contractors 7 through 17 as Category 2. It would seem that contractors 1, 2 and 4 would be classified as Category 2 and most, if not all, of contractors 7 through 17 would be classified as Category 3.

> Response: We will continue to monitor results of audits at all of these contractors to ensure that the assigned ratings are indicative of contractor actions.

Question No. 5

DCAM 12-705(c)(4) requires DCAA field audit offices to report to Headquarters cases in which the amount of DCAA's recommended price adjustment due to defective pricing was not sustained by the contracting officer, and the auditor and contracting officer were unable to agree on the basis for the reinstatement. In response to our request, DCAA advised that only one such report has been received by Headquarters during the past 8 years. In that 8-year period DCAA has issued 1,349 defective pricing reports. It seems very unlikely that DCAA auditors would be in agreement with contracting officers in 1,348 cases out of 1,349 during the past 8 years. It also would seem that DCAA management, at all levels, would be curious why no reports were being issued and ascertained the reason why. Please comment on this matter.

> Response: CAM 12-705 reporting was established by direction from DoD as an internal means to ascertain settlement trends. Where our auditors felt that contracting officers' decisions were contrary to the auditor's factual knowledge or represented a gross misinterpretation of PL 87-653 a report is to be submitted. If these reports constitute a trend, we were to advise higher levels of authority in DoD. However, each case is basically different, and no significant trends related to PL 87-653 were ever identified.

Question No. 6

The Armed Services Board of Contract Appeals (ASBCA) has altered its positions on defective pricing cases over the years. For example, at one time the ASBCA generally took the position that the effect of any defective cost data was a dollar for dollar increase in the contract price. Now it appears that the cumulative effect of the rulings of the ASBCA are making it virtually impossible for the Department of Defense (DoD) to fully sustain the amounts of defective pricing reported by the Defense Contract Audit Agency. ASBCA rulings on burden of proof, absence of contractor's certificate, natural and probable consequences, reliance upon data, setoffs, significance, submission versus availability of data, etc. are all limiting requirements which are not to be found in PL 87-653. Consequently, it appears that many DoD personnel believe that regardless of the validity of the DoD position it is better to settle with the contractor for amounts less than DoD is entitled to. Otherwise, the contractor will appeal to the ASBCA where it is almost certain that the decision will be in favor of the contractor. Please comment on the following matters:

a. Do you generally concur with the above assessment of the effect of the ASBCA's decisions?

Response: The Boards sometimes have to deal with specific situations that are not clearly covered by applicable laws or regulations and must nevertheless make an equitable decision in light of the surrounding circumstances. Certainly some of the court's decisions have had a limiting affect on the Government's ability to recover contract overpricing due to defective pricing, notably the ability of a contractor to propose setoffs to Government recoveries and the need for a certificate of current cost or pricing data. However, the court's decisions on submission versus availability of data and the natural and probable consequence theory have assisted the Government's recovery rights.

b. Do you believe the ASBCA decisions have influenced DCAA auditors' defective pricing audits? For example, would some instances of defective pricing reported and sustained in the late 1960s and early 1970s not be reported today because DCAA believes it would not be sustained today.

Response: Since the Agency's guidance for the performance of defective pricing compliance reviews is continually revised to conform with ASBCA decisions, the courts' decisions have affected the Agency's methods of performing the reviews and affected program results.

c. Has DCAA had to revise its guidance to its auditors because of ASBCA decisions? If so, elaborate.

Response: ASBCA No. 15084 (73-1, BCA 9859, Libby Welding Company, Inc., dated 21 December 1972) and ASBCA No. 16494 (73-2, BCA 10,157, Lockheed Shipbuilding and Construction Company dated 29 June 1973) established that a Certificate of Current Cost or Pricing Data is a necessary prerequisite to contractor liability for defective pricing. DCAA's guidance on defective pricing was revised to read as follows: "In the event the contracting officer advised that no certificate was obtained, the auditor will not perform a postaward audit and the pricing action will be eliminated from the universe for selection of contracts."

ASBCA No. 10305 (65-2, BCA 5280, American Bosch Arma, dated 17 December 1965) and ASBCA No. 13338 (69-1, BCA 7663, Lambert Engineering, dated 30 April 1969) established that a price negotiation conducted on a lump sum basis does not bar the Government from recovery due to the natural and probable consequence of the defective pricing. DCAA's guidance on defective pricing incorporates the natural and probable consequence theory.

ASBCA No. 16458 (73-2, BCA 10,119, Paceco, Inc., dated 30 May 1973), stated that the inadvertent omission of the price reduction clause does not prevent Government recovery of overpricing due to defective pricing. An integral part of DCAA's guidance on defective pricing is that compliance reviews for defective pricing are not dependent on a contract price reduction clause.

ASBCA No. 15442 (74-1, BCA 10,482, Norris Industries, Inc., dated 7 February 1974) established that contract underpricing due to defective pricing may be offset against governmental recovery of contract overstatements due to defective pricing. The DCAA guidance on defective pricing compliance reviews includes audit steps for the review and evaluation of contractor proposed setoffs.

Question No. 7

On April 30, 1981 the Deputy Secretary of Defense issued a memorandum whose subject was "Improving the Acquisition Process." It contains a number of recommendations commonly referred to as "the Carlucci Initiatives." Recommendation 10 dealt with changing 10 USC 2304 so that a contract or revision thereto would have to be at least $500,000 instead of the then existing threshold of $100,000 to be subject to PL 87-653. The recommendation stated "raise threshold for contractor costing data from $100K to $500K to accommodate inflation and reflect current auditing procedures (paperwork load is such that only data for contracts over $500K is actually audited today)." On June 3, 1981 the Under Secretary of Defense for Research and Engineering testified before the Legislative and Security Subcommittee of the Committee on Government Operations, in support of on H.R. 3519 and a provision to raise the threshold. Please answer the following questions:

a. Did the Deputy Secretary, Under Secretary of Defense for Research and Engineering or other initiators of Recommendation 10 ask you if DCAA was auditing contractors' pricing proposal under $500,000? If so, who asked you and what was your response?

Response: Before I answer, I would like to point out that Recommendation 10.b. covers a change to U.S. Code subsection 2306(b), titled Truth-In-Negotiations Act, which concerns postaward defective pricing audits. Your question addresses preaward audits of contract pricing proposals. Postaward defective pricing audits and preaward proposal audits are both important but they are different in nature and in the cost benefit criteria that applies. Going back to your question, the initiators of Recommendation 10, to the best of my knowledge, did not ask whether DCAA was performing preaward audits of price proposals under $500,000. Mr. Bob Trimble, previously in charge of the acquisition policy office in DoD did ask if we review contracts less than $500,000 for defective pricing. My answer was almost never.

b. If you were not asked about DCAA's audits of proposals under $500,000 did you advise any of the initiators of Recommendation 10 whether DCAA was in fact auditing contractors' proposals under $500,000? If so how, when and to whom was this information communicated?

Response: We understood the statement "only data for contracts over $500K is actually audited today" to apply to postaward defective pricing audits. Very few contracts under $500,000 are reviewed on a postaward basis for defective pricing. The GAO requested and received detailed information in October 1981 on cost savings from audits of price proposals under $500,000. In December 1981, DCAA wrote to the Chairman of the DAR Council, who reports to the Under Secretary, presenting data on audits under $500,000 and objecting to the increase in thresholds.

c. If DCAA was auditing contractors' pricing proposals under $500,000 about how many proposals were audited during 1981?

Response:

	Number of Proposals Reviewed Less Than $500,000
Firm-Fixed-Price	11,262
Fixed-Price-Incentive	588
Cost-Type	2,974
Other (Redeterminable)	204
Total	15,029

d. Would you support legislation to lower the threshold to $100,000?

Response: I understand that Senate Bill 338 was recently amended to lower the threshold for certification of cost or pricing data to $100,000. I am in favor of the lower threshold for the following reasons.

A reduced threshold will permit Government recovery of contract overpricing caused by defective pricing on additional contracts. In addition, the lower threshold would allow for varying thresholds related to proposal reviews.

Question No. 8

DAR 3-801.5(b)(1) and (2) provide policy relating to when contracting officers shall request field pricing support reports (which include an audit report from DCAA). For sometime this policy provided that reports were required for all firm fixed price proposals over $100,000, all fixed price incentive proposals over $250,000, and all cost reimbursement type proposals over $250,000. On December 27, 1982 this policy was changed to raise the threshold for requiring audit reports to $500,000 for all pricing proposals regardless of type. Please answer the following questions:

a. Did the Under Secretary of Defense for Research and Engineering, who has responsibility for this policy, ask you for your views on raising the audit report threshold requirement to $500,000 for all pricing proposals? If so, who asked you and what was your response?

Response: The Under Secretary of Defense for Research and Engineering did not ask DCAA directly for its views on raising the DAR 3-801.5 threshold; however, the preaward pricing threshold issue was presented to the Pricing Subcommittee of the DAR Council in early 1982. The DCAA representative on the DAR Pricing Subcommittee reiterated the previous DCAA objection to the increase in postaward defective pricing thresholds required by PL 97-86 and also objected strenuously to extending the legislated increases to totally new areas; i.e., increased thresholds for field pricing support and audit reports. At that time, DCAA furnished extensive information on cost savings resulting from pricing audits under $500,000. This information was included in a memorandum on the subject which the Chairman of the Pricing Subcommittee sent to the DAR Council.

b. If your were not asked about raising the audit report threshold requirement to $500,000 for all pricing proposals, did you advise the Under Secretary of Defense for Research and Engineering of your views on raising the threshold? If so, how, when and to whom was this information communicated?

Response: Please refer to our previous response.

c. How many dollars of hard cost savings resulted from the audit of (i) firm fixed price proposals under $500,000 and (ii) fixed price incentive proposals under $500,000 for 1981 and 1982? Also, how much did these audits cost DCAA to perform. Finally, what is the ratio of costs saved to DCAA's cost of performing these audits?

Response:

MY 1981	Firm Fixed Price	Fixed Price Incentive
Net Savings (000)	$133,189	$ 6,450
Estimated DCAA Cost To Perform Analyses (000)	$ 9,005	$ 465
Savings/Cost Ratios	14.8:1	13.9:1
MY 1982		
Net Savings (000)	$179,486	$ 4,380
Estimated DCAA Cost To Perform Analyses (000)	$ 8,264	$ 312
Savings/Cost Ratios	21.7:1	14.0:1

d. Do you believe the savings attained in the past warrant lowering the thresholds in DAR 3-801.5(b)(1) and (2) back to $100,000 for firm fixed price proposals and $250,000 for fixed price incentive proposals?

Response: Yes.

Question No. 9

It is understood that DCAA has a rather detailed system for determining what contracts to select for defective pricing audits. Would you please explain how the system works and describe what constitutes a defective pricing audit. That is, do you count a contract as audited simply because you compare costs incurred with the negotiated or some other limited comparisons or do you only consider a contract as audited if you actually examine the contractors cost data?

Response: Because we know that only a portion of our reviews will result in reported instances of defective pricing, we have developed several techniques that enable us to concentrate efforts on contracts most susceptible to overpricing. Our recent history shows a one in four relationship.

The Agency's early warning system places emphasis on the identification of potential defective pricing situations. For example, we look for pricing actions which were completed long after the review of the proposal. This early warning may be thought of as a flagging type system and is essentially accomplished at the time we review the PNM.

A contract selection matrix plan was developed to assist field audit offices in the selection of pricing actions. The plan is based on the results of previously completed defective pricing compliance reviews, and emphasizes large dollar value contracts.

DCAA also uses the stop-n-go technique to cease audit work when preliminary effort, including the comparison of actual to negotiated costs, indicates little or no likelihood of contract overpricing due to defective pricing. Defective pricing compliance reviews performed only through the preliminary audit steps are considered a completed review.

Question No. 10

It is understood that you devote 3 percent or less of your staff resources to defective pricing audits. How do you justify devoting such a limited amount of your staff resources to this work?

Response: As you know, DCAA is responsible for the accomplishment of numerous programs, most of which have higher saving/cost ratios than that experienced by our defective pricing compliance program. The allocation of scarce resources goes beyond the simple assignment of subjective percentages. Instead, management must balance anticipated Government savings for each program with the requirement to perform individual bid proposal evaluations, incurred cost audits, operations audits, system surveys, and public law compliance reviews.

DCAA does not specify levels of effort for the defective pricing program; rather the decision is made at the field audit office level. We believe this management philosophy results in the most savings for the taxpayers, recognizing resource constraints.

Question No. 11

Is there a relationship between the time spent and the significance of defective pricing findings?.

Response: There is no direct correlation between hours expended on defective pricing compliance reviews and the amount of alleged defective pricing. Sometimes obvious and significant amounts of defective pricing are detected in the early stages of the compliance review. Other situations arise where because of the complexity of the pricing action, a substantial amount of DCAA effort is required to ensure compliance to PL 87-653.

Question No. 12

It is understood that on the average DCAA spends only about 150 hours doing a defective pricing audit. How can this possibly be sufficient to audit multmillion dollar contracts, or is your effort simply limited to what might be termed "skimming" in areas where there appears to be great potential for defective pricing?

Response: I am unable to determine the source for your statement that DCAA spends 150 hours per defective pricing assignment. However determined, this number represents an average of effort expended. An analysis of MY 1982 assignment hours disclosed that 30 percent of the audits were completed with less than 40 auditor hours. Many of these reviews were curtailed based on the auditor's preliminary audit steps which indicated that the pricing action was not based on defective cost or pricing data. At the other end of the scale, 19 reviews were completed with at least 500 direct audit hours and six of these reviews ranged between 1,007 hours and 2,529 hours.

Question No. 13

It is understood that DCAA auditors generally concentrate on materials and subcontract costs when doing defective pricing audits. How can this practice be justified? Do you have a plan for assuring that all cost elements are subjected to audits?

Response: The Agency's guidance for the performance of defective pricing compliance reviews requires the review and evaluation of all contract cost elements. Implementation of Agency guidance is reviewed by supervisory personnel at all levels.

I do not believe that DCAA auditors are forsaking the review of direct labor hours, indirect expense rates, etc., for the evaluation of material and subcontract costs. Instead, DCAA auditors use their professional judgments, based on the results of preliminary audit steps, to concentrate audit efforts on cost elements having the greatest potential for defective pricing.

Question No. 14

It is understood that frequently, in evaluating defective pricing reports, contracting officers will determine that missing or incorrect data underlying the audit report finding was furnished or corrected during the negotiation process. Doesn't DAR 3-811 require that such data be identified in the procurement negotiation memorandum furnished DCAA? Regardless about the content of the PNM, why isn't the contracting officer approached on this possibility once a potential defective pricing issue is identified rather than waiting until after the audit is fully completed and a report issued. This might save time and effort that could be devoted to other audits.

> Response: One of the steps in performing a defective pricing review is to determine exactly what cost or pricing data was submitted by the contractor and relied on by the contracting officer. This is why we get copies of negotiation memorandums. I do not see a point to having an "exit" conference with a contracting officer before we issue a defective pricing report. If there was data submitted that renders our report recommendations invalid, or if the contracting officer did not rely on the data, he need only state this and dispose of the issue. I want to avoid getting involved in endless discussions and negotiations with contracting officers delaying issuance of our reports. This approach could well affect our independence, which we guard vigorously.

Question No. 15

Is DCAA's effectiveness in performing defective pricing audits limited in any way by contractors refusing your auditors access to records or delaying access? How serious is the problem and what are you doing about it. Identify any contractors where DCAA has such an access to records problem.

> Response: DCAA's defective pricing compliance review program is not adversely affected by an access to records problem. DCAA Headquarters has no reported incidents of access to records problems concerning the performance of defective pricing compliance reviews.

Question No. 16

What do you see as the major problems that cause delays of up to 5 years to resolve defective pricing cases and what can be done about these problems?

Response: It is natural to expect some delays in the resolution of alleged defective pricing especially when the findings pertain to complex or unusual issues. Some of the primary reasons for delays involve the appeals process and contractor setoffs to alleged defective pricing.

Question No. 17

Does the contracting officer solicit DCAA's review and approval of proposed settlements of defective pricing reports? If not, would you recommend this in an effort to expedite settlements and increase recoveries?

Response: . It is common practice for the Contracting Officer to include DCAA representation in the review and evaluation of contractor comments or proposed setoffs.

Question No. 18

What actions do you believe are necessary to make postaward audits under Public Law 87-653 more effective?

Response: The most effective means of strengthening DCAA's defective pricing compliance program is to revise Public Law 87-653, as follows:

(i) Eliminate the ability of a contractor to offset alleged defective pricing. Through allowance of setoffs, the Government is inviting a submission of carelessly prepared proposals, and to an extent, permitting contract renegotiations.

(ii) Provide for strong monetary penalties when deficiencies remain uncorrected.

(iii) Provide for visibility of subcontracts subject to PL 87-653.

Question No. 19

DCAA's defective pricing audit program is exclusively targeted to finite contract awards. There is no program for defective pricing audits of forward pricing rate negotiations for labor and indirect expense rates. However, the results of these bid rate negotiations greatly influence the pricing of individual contracts. The GAO made a recommendation to DoD (PSAD-78-127 dated July 20, 1978) to implement such a program on a pilot basis. The recommendation was rejected. Does DCAA have any plans to expand the defective pricing audit program to cover bid rate negotiations? If not, what is the agency's current position on this matter?

Response: While DCAA's defective pricing compliance program does concentrate on large dollar value pricing actions, the program is not exclusively targeted to finite contract awards. The review and evaluation of direct labor rates and indirect expense rates negotiated under a forward pricing rate agreement represent an important aspect of our program. In this regard, our 6 October 1980 guidance entitled "Postaward Audits" represents the most recent policy on defective pricing compliance reviews of forward pricing rate agreements. A recap of this guidance is as follows:

"It is important that auditors be alert to conditions that should have been disclosed during contract negotiations. With respect to negotiated or agreed to rates, these conditions may be observed or noted in any phase of our audits at a contractor location. The discovery of a defective pricing situation is generally most likely to occur when the auditor is reviewing a new forward pricing rate proposal. Postaward audit programs should include procedures to determine that at the date of agreement on price, (the) contractor furnished accurate, complete, and current cost or pricing data in support of forward pricing rates."

During MY 1982, DCAA expended approximately 4,000 direct audit hours on the review of 29 forward pricing rates agreements. Additional efforts were expended on this segment of our compliance program in conjunction with the review of individual pricing actions.

FOR RELEASE ON DELIVERY
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April 14, 1983

Statement by Acting Deputy Inspector General
Department of Defense
Derek J. Vander Schaaf, on Defective Pricing Reviews
before the Committee on Governmental Affairs
United States Senate
April 14, 1983

Mr. Chairman and Members of the Committee:

I am pleased to testify today on defective pricing in Department of Defense (DoD) contracts. I have served as the Principal Deputy Assistant to the Secretary of Defense (Review and Oversight) for the past year, and I share many of your concerns about defective pricing and its impact on the American taxpayers. I shall provide my views on several areas identified by the Committee staff and suggest a few changes that I believe could benefit us all. Before I address specific issues, however, I would like to explain what the Office of the Assistant to the Secretary for Review and Oversight and its successor, the Office of the Inspector General, have done in the defective pricing area.

Contract Audit Followup

When the Office of the Assistant to the Secretary of Defense (Review and Oversight) was created, one of the Secretary's primary concerns was audit followup. After several years of effort, the Department, in January 1981, issued policy for following up on General Accounting Office and internal audit reports, but still had not issued policy for following up on contract audits. Developing contract audit followup policy was one of our highest priorities. We worked on this beginning in May 1981 and on August 31, 1981, DoD issued Directive 5000.42, "Policy for Followup on Contract Audit Recommendations." This was only months after the Review and Oversight Office was established.

DoD Directive 7640.2 (formerly 5000.42) delineates policy for the timely resolution and disposition of significant contract audit reports. The Directive requires that DoD components track and report on the status of certain postaward audits, including all defective pricing reports, from the date of receipt through final disposition. If the contracting officer disagrees in the auditor's recommendation for a downward price adjustment due to alleged defective pricing, the Directive requires that the disagreement be brought promptly to the attention of a designated independent senior acquisition official or board for review. The Services and DLA have designated different individuals or boards at each procurement and contract administration activity. The review official or board is required to provide to the contracting officer a clear, written recommendation concerning the issue in question. A copy must be sent to the contract auditor. The Directive also requires that the contracting officer provide written feedback to the auditor on the final disposition of the audit report.

I am responsible for seeing that Directive 7640.2 is successfully implemented. My office monitors the status reports from the Military Departments and Defense Agencies, evaluates performance, develops policy and provides guidance to DoD components where needed.

The most recent contract audit followup status report covered the six month period ending September 30, 1982. Chart 1 summarizes the components' overall performance during the reporting period. There were 557 audit reports more than six months old at the start of the period. They involved questioned costs of $1.1 billion. During the reporting period, DoD components closed 196 of these reports involving about $266 million in questioned costs. An additional 220 reports became overaged during the reporting period. As a result, the number of reports over six months old increased to 581, with total questioned costs of about $1.3 billion. About 10 percent of these reports (56) are being litigated before the Armed Services Board of Contract Appeals or the Court of Claims.

Chart 2 shows more information on the September 30, 1982 reporting period. It includes the number of reports and related costs questioned for audit reports more than six months old by type of report. Although defective pricing reports account for only about 3 percent of the total number of contract audit reports performed each year, the chart shows that they accounted for about 25 percent of the total number of open reports over six months old and about 16 percent of questioned costs. And, my office has found they are often especially difficult to close out.

Our followup efforts to date have focused primarily on the development of DoD Directive 7640.2 and the prompt disposition of audit reports issued before 1980. Chart 3 shows the number of overaged reports by year of issue and component. It also shows the increase or decrease by year and component between March 31, 1982 and September 30, 1982. The components made considerable progress in closing out older audit reports during the period. Although the total number of overaged reports increased by 24, the number of overaged reports issued prior to 1981 decreased by 85.

Many of these older reports were defective pricing cases. We requested and received from the Military Departments and the Defense Logistics Agency (DLA) explanations of the causes for delays in disposing of these reports and definitive action plans for their final disposition. Since we began emphasizing the closure of these older reports, several defective pricing reports were dispositioned resulting in contract price adjustments and recoveries of funds due the Government.

In response to one of our followup inquiries, one major DoD procurement activity recently reported that a 1979 defective pricing case was settled as part of negotiations for an FY 1982 production contract on the same program. My office immediately expressed concern that closing defective pricing cases in this manner may not result in an equitable adjustment between contracts, and makes it difficult, if not impossible, to track and account for defective pricing recommendations. A few days later, we advised the Military Department of our intent to review the closure of the audit report in question. Shortly afterwards, the contracting officer and the contractor negotiated a downward price adjustment of the original (1973) contract. Restitution was made in the form of a check for $40,000 from the contractor to the Government.

More recently, one of my staff members visited another major procurement activity to review the negotiated settlement of five defective pricing cases at one contractor location. We found that the settlement did not result in downward price adjustments to the original contracts. Instead, the settlement requires that the contractor provide future goods or services valued at $2 million on a current production contract with no increase in contract price. The settlement not only involves transfers of funds between contracts and fiscal years, but also involves transfers between governments, since one of the defective pricing cases occurred on a foreign military sales contract.

I am consulting with the acquisition community on this practice. I think it would be best to discontinue the practice of settling defective pricing cases against other contracts immediately. The practice could result in shifting appropriations to another purpose and another program year as a result of the overpricing of earlier contracts. It could also provide an incentive to contracting officers to settle for less than the full amount of the recommended price adjustment in order to advance certain programs. In other words, the contracting officer may be tempted to sacrifice the Government's overall interests in order to make him or herself look good by benefiting his or her assigned program.

The followup status reports and our field trips show that, prior to DoD Directives 5000.42 and 7640.2, the disposition of defective pricing reports was a relatively low priority for contractors, contracting officers and auditors. For obvious reasons, contractors were rarely anxious to settle defective pricing cases. The contracting officers considered them low priority because they were frequently under considerable pressure to complete negotiations on major procurements or contract close-outs. Unlike many other contract audits, defective pricing cases did not have to be negotiated by specific due dates. Therefore, they were the assignments that were most often postponed.

Funding may have been another consideration. The negotiation of major procurements involved current funds, while defective pricing cases normally involved prior year funds. Putting it another way, cost savings from negotiated procurements directly benefited the program office by providing additional funds for existing programs. Defective pricing recoveries, on the other hand, benefited the U. S. Treasury but provided no monetary benefits to the program office responsible for its settlement.

Perhaps another explanation for the low priority assigned to defective pricing cases is the natural tendency by the contracting officer to view the auditor's report as a negative reflection on his performance as well as the contractor's. Some contracting officers may be defensive about the defective pricing issues raised by some audit reports.

DCAA has also assigned a low priority to defective pricing reviews. In 1972, DCAA established a policy that each audit office would spend at least 2 percent of its direct audit effort in the performance of defective pricing reviews. In 1979, DCAA dropped the minimum performance requirement and substituted a priority plan. Each office must now assign first priority to demand audits and second priority to defective pricing reviews. Although second priority may sound impressive, defective pricing reviews are actually far down the list because demand audits include all requests for audits from acquisition officials which must be completed within a specific timeframe such as bid and proposal reviews, equitable adjustments, terminations, progress payments, etc. DCAA recently spent about 3 percent of its total audit efforts on defective pricing reviews, so there has been little increase.

DCAA has assigned to defective pricing reviews priority that is commensurate with the payback to the Government they anticipate from performing such reviews. I believe that if defective pricing reviews were afforded the attention they deserve from contracting officers and auditors, their payback would warrant a higher audit priority. Therefore, I believe DCAA should devote more of its resources to defective pricing reviews. My initial thought is that DCAA should spend about 5 to 7 percent of its audit efforts in defective pricing reviews. The Inspector General's office, which now has responsibility for policy and oversight of DCAA will review the controls and methods DCAA uses in determining the number of defective pricing reviews. After we complete our analysis, the Office of the Inspector General will make recommendations for changes in frequency of defective pricing audits. Of course, Mr. Chairman, you realize that the OIG was recently organized. The Department went through extensive debate on who is responsible for contract audit policy. OIG has that responsibility, and the matter is now settled.

Contract Audit Oversight and Policy

My office's responsibilities also include the oversight and evaluation of DCAA audit activities and the issuance of contract audit policy. My staff is currently reviewing all defective pricing reports issued by DCAA during the six month period ending June 30, 1982. This review is limited to cases of over $1 million. We will also be sampling some of the defective pricing audits done by DCAA which did not disclose defective pricing. We want to determine the adequacy, sufficiency, scope and reporting by DCAA for defective pricing audits. Our staff will be alert for circumstances that warrant referral to my criminal investigative organizations.

Another current contract audit oversight effort is a review of the quality and timeliness of contract and internal audits of subcontractors' price proposals. As part of this review, we observed deficiencies in the multiyear procurement for 294 UH-60A helicopters. The major deficiency found was that the prime contractor's price proposal was not fully documented with respect to subcontractors' cost or pricing data. There was no indication that the contracting officer had other current cost or pricing data available on which to evaluate the subcontractors' pricing proposals. He determined that the Government was receiving a better price on a cost per helicopter basis. However, he had no assurance it was the best price without certain subcontractor cost and pricing data. Instead of waiting for this data, the contracting officer assumed that the prime would be able to negotiate lower prices with his subcontractors. After the prime contractor completed negotiations with the Government, the prime contractor was able to negotiate substantially lower prices with their subcontractors. We recommended that DCAA perform a defective pricing review on all major subcontracts. We also asked DCAA to review prior UH-60A helicopter procurement for defective pricing.

Variance Between Recommended and Sustained Price Adjustments

There are many reasons for the variance between recommended and sustained price adjustments reported in DCAA's Management Information System.

In some cases, auditors are able to develop very strong support for defective pricing allegations. In others, auditors may have strong indications that defective pricing took place, but very little actual support for their positions. The auditor must express an opinion as to whether or not defective pricing may have taken place during negotiations, and provide the best available support for his opinion. The contracting officer may or may not agree with the auditor's position. For example, the defective pricing the auditor identified may have already been addressed in contract negotiations to which the auditor was not privy.

The contracting officer must frequently negotiate a fair and equitable settlement with contractor officials. This process often results in significant variances between amounts recommended by auditors and sustained by contracting officials. Errors or omissions by the auditor or contracting officer may play little or no part in these cases.

Performance reports submitted by DCAA to my office in 1982 indicate that only a small proportion of the questioned amount is actually sustained. I believe that the variance is too high. As I said earlier, defective pricing has historically been afforded a low priority by auditors and contracting officers. In many cases, the responsible parties failed to make serious attempts to reach a settlement for months or years. As a result, the auditors or other technical experts were no longer available to testify. This diminished the Government's ability to litigate such cases successfully. The contracting officers often felt compelled to negotiate settlements rather than take their cases to court.

The DoD components are now developing implementing instructions for DoD Directive 7640.2. As full implementation takes place, I expect to see an increase in the overall rate of sustention for defective pricing recommendations. I will closely monitor the Department's progress in this area, and continue to search for ways to reduce the gap between recommended and sustained amounts.

Price Negotiation Memoranda

DAR 3-811, Record of Price Negotiation, requires that the contracting officer prepare a record of the basis for determining price in sufficient detail to show the principal considerations the parties made during negotiations. The existence of a well prepared price negotiation memorandum (PNM) is crucial to the strength of the Government's position in most defective pricing cases. Without a well prepared PNM, the Government is most susceptible to being faulted by the courts as being too speculative as to the causes of overpricing.

Now that Directive 7640.2 has been issued, the PNM serves a dual function. It remains important as a supporting document for defective pricing allegations. It also serves as a record of the resolution of any differences of opinions which may have developed between the auditor and the contracting officer as a result of the auditor's report. The PNM documents the final disposition of the auditor's recommendations, and provides feedback to the auditors for audit planning purposes. The auditors may wish to redirect their future efforts based on the results of prior audit recommendations.

If the contract auditor fails to receive a PNM within a reasonable timeframe following negotiations, the auditor should contact the report recipient to determine why. If the report recipient fails to provide a satisfactory response, the auditor should elevate the problem up the chain of command.

One problem for DCAA is that the auditor frequently has no way of knowing when negotiations are held or completed. Even when the auditor is invited to attend negotiations, he/she rarely attends the negotiations from beginning to end. Usually the auditor is invited to provide technical input on only a portion of the elements to be negotiated. In addition, many of the auditors' pricing reports are never subjected to negotiations because the contractor's bid is revised or withdrawn by the contractor or eventually rejected by the Government. Therefore, the auditor normally depends on the contracting officer to provide either a PNM or a notification of no action.

When the PNM is received by DCAA, the auditor is required by DoD Directive 7640.2 to review it for significant differences of opinion on matters raised in the audit which were not referred by the contracting officer for an independent review prior to negotiations. When such differences are found, the auditor is required to notify the contracting officer of the difference and recommend that similar differences be submitted for independent review in the future. The PNM is then retained for potential defective pricing review.

The responsibility for the timely and thorough preparation and distribution of PNMs clearly rests with the contracting officers. Members of my staff and internal audit reports from the Military Departments have indicated that performance in this area needs improvement. My staff will followup on the Military Departments' efforts to improve the development and distribution of PNMs and attempt to develop specific guidance where needed.

Defective Pricing Disposition Memorandum

DAR 3-812, Disposition of Post Award Audits, requires that contracting officers prepare a memorandum for each defective pricing report indicating whether or not the auditor's allegations were upheld and the results of final actions taken on the auditor's recommendations. A copy of the memorandum is required to be forwarded to the auditor.

Contracting officers have historically taken several months or years to settle defective pricing cases. Therefore, auditors do not become overly concerned if the disposition memorandum is not received in a period of several years. Nevertheless, many DCAA offices send out reminders to report recipients asking for an update of the status of open reports. The Office of the Inspector General continues to push for settlement within six months unless the defective pricing audit goes to litigation. I do not believe that defective pricing cases should take years to resolve unless they are docketed as ASBCA cases and are outside of the contracting officer's control. I also plan to monitor the speed and accuracy with which disposition memorandums are distributed to auditors. I do not believe that the auditors should have to make repeated inquiries as to their status.

DoD Directive 7640.2 now requires that all defective pricing reports, without regard to amount, be tracked and reported by the Military Departments and Defense Agencies. The components' implementing instructions for this new requirement are due on April 28, 1983, and their first status reports are due on October 31, 1983.

Contracts Awarded Without Defective Pricing Clauses or Certificates

The awarding of a contract subject to Public Law 87-653 without a defective pricing clause does not necessarily negate the need for defective pricing review. If the contracting officer or auditor suspects that defective pricing data were relied upon by the Government to negotiate the contract price, a defective pricing review may be desirable. The failure to include the clause may preclude full recovery of the amount in question. Other means may be available, however, for at least partial recovery.

If the contracting officer fails to obtain a certificate of current cost or pricing data at the time of negotiations, DCAA currently does not perform a defective review. I believe that defective pricing reviews should be performed in such cases, however, and I intend to issue new policy, or seek legislative or administrative remedies if necessary.

The Court of Claims has stated that "The duty to furnish accurate, complete, and current data is a duty imposed on Government contractors by a statute, and, therefore, that duty cannot be waived by a Government agent."

Government negotiators or contracting officers should not be able to avoid, either deliberately or through their negligence, the intent of statutory regulations.

The Justice Department takes the position that there can be civil fraud liability under the False Claims Act for any defective data even in the absence of a certificate.

Problem Contractors

The contract audit followup status reports for the six month period ended September 30, 1982 include 145 defective pricing cases on contracts awarded to 45 separate contractors. These have been open for at least six months. A summary of the number of reports and total amounts questioned, detailing the top 10 contractors, follows.

Contractor/Location	No. of Reports	Total Questioned
General Dynamics Fort Worth, TX	2	$52,912,000
Grumman Aerospace Corp. Bethpage, NY	32	29,574,000
McDonnell Douglas Corp. St. Louis, MO	26	25,934,000
Pratt & Whitney Aircraft East Hartford, CT	3	22,631,000
Newport News Shipbuilding Newport News, VA	2	9,993,000
Fairchild Republic Farmingdale, NY	3	8,134,000
Chrysler Corp. Detroit, MI	4	8,077,000
Lockheed Marietta, GA	6	7,513,000
Sperry Rand Great Neck, NY	6	6,998,000
FMC Corp. Minneapolis, MN	3	3,907,000
All Others	58	32,070,000
Total	145	$207,743,000

This list does not necessarily show contractors with historical problems in defective pricing. It merely shows where contracting officers are experiencing problems in disposing of defective pricing reports within six months of issuance. We have not initiated any actions based on the number of cases outstanding at specific contractor locations.

The contract audit followup status reports for the six month period ended September 30, 1982 include five open defective pricing reports with recommended price adjustments in excess of $5 million. They are as follows:

Contractor/Location	Contract Number	Dollar Value
Grumman Aerospace Corp. Bethpage, NY	N00019-78-C-0014	$9,893,000
Newport News Shipbuilding Newport News, VA	N00024-67-C-0325	$9,486,000
Pratt & Whitney Aircraft East Hartford, CT	F33657-70-C-0600	$21,350,000
Fairchild Republic Farmingdale, NY	F33657-78-C-0135	$6,471,000
General Dynamics Fort Worth, TX	F33657-75-C-0310	$52,800,000

These defective pricing cases were reported as over six months old as of September 30, 1982. (Cases that are open for less than six months are not required to be reported.)

The following are defective pricing reports issued by DCAA during the six month period ended June 30, 1982 with recommended price adjustments in excess of $5 million.

Contractor/Location	Contract Number	Dollar Value
McDonnell Aircraft Company St. Louis, MO	F33657-79-C-0779	$14,414,655
McDonnell Aircraft Company St. Louis, MO	F33657-79-C-0779	$13,344,107
Pratt & Whitney Aircraft East Hartford, CT	F33657-80-C-0218	$15,327,765
Boeing Aerospace Company Seattle, WA	F19628-80-C-0007	$12,826,000
Boeing Military Airplane Wichita, KS	F33657-79-C-0416	$12,018,251
Boeing Military Airplane Wichita, KS	F33657-79-C-0416	$10,278,161
Newport News Shipbuilding Newport News, VA	N00024-80-C-2023	$11,848,302

At the present time, the Office of the Inspector General is not aware of other defective pricing cases over $5 million.

Certification Threshold

The DoD Authorization Act of 1982 (PL 97-86) raised the threshold for contractors' submissions of certified cost or pricing data to $500,000. The Under Secretary of Defense for Research and Engineering (USDR&E) supported the change in testimony on June 3, 1981 before the Legislation and National Security Subcommittee of the Committee on Government Operations. He believed that the thresholds set by the original law posed a burden on DoD resources and extended the lead time of the procurement process. The Defense Acquisition Regulations (DAR) was changed in late December 1981 to eliminate audits of proposals under $500,000.

The Assistant to the Secretary of Defense for Review and Oversight (Inspector General-designate) expressed concern about the proposed increase in certification threshold and auditing threshold in his memorandum to USDR&E dated January 4, 1982. He pointed out that DCAA reported cost savings of about $160 million from audits of firm fixed-price proposals under the $500,000 level during FY 1981. DCAA reported similar savings experience in reviews of fixed-price incentive proposals under $500,000. These savings were achieved with the expenditure of between $7 and $8 million in audit resources (roughly $20 saved for every $1 of audit effort).

The Office of Inspector General believes that returning the threshold to $100,000 for contractor certification adds no administrative effort for DoD and very little effort for the contractors. Contractors will be inclined to submit accurate, complete and current proposals since any contract over $100,000 will be subject to price adjustment under the provisions of PL 87-653.

The Office of Inspector General believes that another advantage occurs when the contract auditor uncovers a poor condition in the contractor's estimating methods while doing other defective pricing reviews. The lower threshold will give the auditor the opportunity to look at contracts valued between $100,000 and $500,000 to determine if the same condition exists and to recommend the necessary contract adjustments. Without the certificate the auditor would not be allowed to pursue a contract price adjustment under PL 87-653. He would have to seek other more difficult means such as use of the False Claims Act.

Monetary Penalties

Defective pricing involves the failure of a contractor to provide current, complete and accurate cost or pricing data. Most defective pricing violations do not constitute fraud. If the violation does constitute fraud, the False Claims Act provides the Government with criminal remedies. Violations can result in fines of up to $10,000 and imprisonment for up to five years.

As the Assistant to the Secretary of Defense (Review and Oversight) testified last year, if Congress enacted a Program Fraud Civil Penalties Act similar to the one introduced by Senator Roth (S. 1780), it would provide another tool for use in defective pricing cases. The act would provide administrative penalties for fraud that can be proven under a lower standard of proof than the False Claims Act. The Office of the Inspector General continues to support such an act.

Even if there is no fraud in a defective pricing case, the contractor often benefits from interest-free use of Government funds. In many cases, DCAA does not perform the defective pricing review and detect the violation until two or three years after the contract price was negotiated. The case may require months or years to negotiate or litigate a settlement. I believe that the contractor should be required by law to reimburse the Government for the use of its funds at the prevailing U.S. Treasury rates. In addition to stopping the interest free use of Government funds, such a law would provide contractors with an incentive for resolving defective pricing cases in a more timely manner, since interest should accrue from the date of contract to the date of repayment.

Referrals for Criminal Investigation

I believe that in every instance of defective pricing where there is a possibility that the certificate was in any part false, fraudulent or fictitious, the matter should promptly be referred to a DoD investigative agency. I have instructed the Assistant Inspectors General for Auditing and Criminal Investigations Oversight and Policy, OIG, DoD to be alert to these kinds of cases. A list of potential fraud cases involving defective pricing and referred for investigation was provided to the Chairman of this Committee on March 28, 1983. We are also in the final stages of negotiating a Memorandum of Understanding between DoD investigative agencies and DCAA which will help to ensure early and direct reporting of potential criminal violations.

Use of 100 Additional Spaces

Public Law 97-252 specified that at least 100 spaces be transferred to the IG, DoD for contract audit operations. Ten of the 100 spaces will be used to augment contract audit policy, oversight, and followup functions in the Office of the Assistant Inspectors General for Audit Followup and Audit Oversight and Policy. Action is under way to fill these vacancies.

The balance of 90 spaces have been allocated to the Office of the Assistant Inspector General for Auditing. These 90 auditors will be the major portion of a 168-person organization devoted to acquisition audits. (The additional 78 personnel will come from a realignment of resources and priorities within the Office of the Assistant Inspector General for Auditing.) These 168 personnel will be organized into three major groupings and 14 separate audit teams. The three major groups will be Major Acquisition Programs, Acquisition Support Programs, and Contract Audit Programs.

The Major Acquisition Programs group will consist of four audit teams devoted to reviewing complete weapon systems. For example, these audit teams would review all aspects of a single weapon system, or family of systems, covering both the DoD management and the contractor(s) management of the program. The teams will be organized along weapon system functional lines (Aeronautical Programs, Land Forces Programs, Naval Forces Programs, and Space Programs).

The Acquisition Support Programs group will do cross-cutting reviews of the same function across many weapon systems or activities. Configuration management, competition in procurement, and life cycle costing would be examples of audits that these teams would conduct. The audit teams will be for Procurement, Contract Administration, Research, Development, Test and Evaluation support and Acquisition management.

The Contract Audit Programs group will consist of six teams. These include four teams of contract auditors and two teams of technical specialists knowledgeable in the technical areas supporting the procurement function (e.g., engineering, cost estimating, quality assurance, and contracting). The technical teams would provide specialized technical assistance to contract audit teams as well as any other audit teams needing it. The majority of their work is expected to be in the major acquisition areas. The contract audit teams will perform reviews of contractors in conjunction with the review of weapon systems, assuring that a comprehensive review of a program or problem area is accomplished. They would also conduct broad reviews of activities that affect DoD contracts and contractors in general. These teams would conduct or assist in audits such as those involving the use of the contract auditor input in negotiations, the authenticity of contractor cost estimates on weapon systems, progress payments, contractor make or buy decisions, subcontractor purchasing procedures and competition therein.

Action to fill all vacancies is under way. Recruitment is Government-wide and open to all sources. As of March 4, 1983, we had mailed over 450 announcements to interested individuals, answered over 700 telephone inquiries, and had 598 qualified applicants. Selection panels have been formed, and applicants are being reviewed.

We plan to bring the first group on board by the end of April. We are hiring by audit team so that as personnel arrive, they will be able to begin work very quickly.

Mr. Chairman, that completes my statement. I am available for questions.

OVERAGED CONTRACT AUDIT REPORTS
SIX MONTHS ENDED SEPTEMBER 30, 1982

	Open as of Apr 1, 1982	Open as of Sep 30, 1982*	Closed During Period*
Number of Reports:			
Army	51	58	26
Navy	157	193	39
Air Force	129	129	48
DLA	220	201	83
	557	581	196
Questioned Costs (000):			
Army	$120,667	$95,827	$58,858
Navy	174,741	270,954	18,027
Air Force	559,483	614,018	136,643
DLA	239,981	303,326	52,345
	$1,094,872	$1,284,125	$265,873

* Navy data cover the period from April 1, 1982 through August 31, 1982

Chart 1

OVERAGED CONTRACT AUDIT REPORTS
AS OF SEPTEMBER 30, 1982

Type of Report	Number of of Reports	Percent of Total	Questioned Costs (000)	Percent of Total
Cost Accounting Standards	124	21%	$152,480	12%
Defective Pricing	145	25%	210,196	16%
Incurred Costs	57	10%	297,381	23%
Indirect Cost Rates	129	22%	397,466	31%
Operations Audits/ Internal Control Reviews	61	10%	108,907	8%
Estimating System Surveys	9	2%	7,806	1%
Claims Proposals	30	5%	73,202	6%
Terminations	0	0%	0	0%
Others	26	5%	36,687	3%
	581	100%	$1,284,125	100%

Chart 2

OVERAGED CONTRACT AUDIT REPORTS
AS OF SEPTEMBER 30, 1982

	Number of Reports by Year Report Issued										
Component	73	74	75	76	77	78	79	80	81	82	Total
Army	0	0	0	0	0	1	4	15	27	11	58
Navy	0	1	0	1	0	8	20	70	82	11	193
Air Force	1	0	1	1	2	3	11	27	53	30	129
DLA	0	0	0	0	4	7	11	54	95	30	201
Total	1	1	1	2	6	19	46	166	257	82	581
Percentage	(1%)				1%	3%	8%	29%	44%	14%	100%

INCREASE/(DECREASE) FROM MARCH 31, 1982

	Number of Reports by Year Report Issued										
Component	73	74	75	76	77	78	79	80	81	82	Total
Army	0	0	0	0	0	(3)	(1)	(5)	5	11	7
Navy	0	0	(1)	(2)	(1)	(4)	(4)	11	26	11	36
Air Force	0	0	0	1	(1)	(2)	(8)	(24)	4	30	0
DLA	0	(1)	0	(1)	0	(3)	(11)	(26)	(7)	30	(19)
Total	0	(1)	(1)	(2)	(2)	(12)	(24)	(44)	28	82	24

Chart 3

RESPONSES TO PRE-HEARING QUESTIONS ASKED OF JOSEPH SHERICK, ACTING INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

Question 1a: If contracting officers are complying with DAR 3-812, why can't DCAA determine with some precision how many dollars of defective pricing reported by DCAA are sustained by contracting officers?

Answer: DCAA should be able to determine the amount sustained where contracting officers comply with DAR 3-812.

Question 1b: If DCAA does not receive the memorandum from the contracting officer as required by DAR 3-812 what action do you believe they should take?

Answer: The auditor should followup with the contracting officer. If unsuccessful, the issue should be elevated up the chain of command.

Question 1c: If all DCAA efforts to obtain a copy of the memorandum required by DAR 3-812 from the contracting officer are not successful should DCAA report this situation to the Head of the procurement office involved? If not, why not?

Answer: Yes.

Question 1d: If there are a substantial number of instances where DCAA has been unable to obtain the memorandums required by DAR 3-812, do you believe that DCAA should report this situation to OASD(C) and OUSDR&E? If not, why not?

Answer: Yes.

Question 2a: If contracting officers are complying with DAR 3-811 and DCAA has determined from the required memorandum what defective data was recognized by the contracting officer should any defective data not identified in the memorandum and subsequently reported to the contracting officer by DCAA not be sustained?

Answer: Not unless there are legitimate offsets, or the recommendations were not fully supported.

Question 2b: If DCAA submits a report to the contracting officer identifying defective data and the contracting officer does not sustain DCAA because he says he was aware of the data, should that data have been identified in the memorandum required by DAR 3-811? If this data was not identified in the memorandumm, what action, if any, do you believe DCAA should take?

Answer: In the ideal situation, the memorandum should contain sufficient detail to identify the data. If it does not, and the auditor has reason to question the contracting officer's position, the difference of opinion should be referred to the independent review official or board in accordance with section D.4 of DoD Directive 7640.2.

Question 2c: If contracting officers are complying with DAR 3-811 and DCAA is using the information in the memorandum properly, should virtually all defective pricing violations reported by DCAA be sustained by the contracting officers?

Answer: Yes, assuming the recommendations are fully supported.

Question 2d: In your oversight of DCAA, have you determined whether DCAA receives copies of the memorandums required by DAR 3-811 in substantially all cases where they are required?

Answer: Field visits by members of my staff and internal audit reports from the Military Departments indicate that DCAA frequently does not receive copies of the memoranda. I will followup on the Military Departments' efforts to improve in this area.

Question 2e: If DCAA does not receive a copy of the memorandum required by DAR 3-811, how can it perform an effective review for defective pricing?

Answer: Without the memorandum, DCAA's review will lose much of its effectiveness. DCAA will be forced to rely on other data which may or may not have been considered during negotiations.

Question 2f: If DCAA does not receive the memorandum from the contracting officer required by DAR 3-811, what action do you believe they should take?

Answer: They should followup with the procurement officials until a copy is received.

Question 2g: If all DCAA efforts to obtain a copy of the memorandum required by DAR 3-811 from the contracting officer are unsuccessful, do you believe DCAA should report this situation to the Head of the procurement office involved? If not, why not?

Answer: Yes.

Question 2h: If there are a substantial number of instances where DCAA has been unable to obtain the memorandums required by DAR 3-811, has DCAA reported this situation to OASD(C) and OUSDR&E? If not, why not?

Answer: I am not aware of any instances reported by DCAA. I can only assume that the reason is that DCAA does not perceive that a problem exists. I think you should discuss this matter with Mr. Starrett.

Question 2i: Have you or do you intend to issue any contract audit policy on the matters discussed above? If so, state what the policy would be.

Answer: I have not developed audit policy because the extent of the problem was unknown by me until very recently. It was determined that my office has audit policy responsibility. I plan to develop audit policy based on the results of these hearings and any followup efforts which may be necessary.

Question 4a: In response to your request for a listing of 10 contractors with the poorest records of P.L. 87-653 compliance during the past 5 years, DCAA provided a list of 6 contractors (Nos. 1-6 below). DCAA also provided defective pricing statistics for MY 1981, MY1982, and the first half of MY1983 for each branch and resident audit office. Data for the 6 contractors identified by DCAA as well as for 11 additional contractors which DCAA statistics indicate a poor history of P.L. 87-653 compliance are shown here.

Contractor	Number of Positive Review	Recommended Amount of Price Adjustment	Hours of Audit Expended
1. AVCO Aero-structures	(see note 1)	(see note 1)	752
2. Gould Inc., Ocean Systems	1	$ 377,000	
3. Emerson Electric	(see note 2)	(see note 2)	
4. Lima Tank Plant	0	0	234
5. General Dynamic Systems, Inc.	5	3,833,000	1,542
6. McDonnell Aircraft	28	48,652,000	8,267
7. Grumman Aerospace Corp.	40	24,469,000	13,122
8. Texas Instruments, Inc.	22	5,193,000	6,765
9. GE Schenectady	12	4,998,000	3,113
10. UTC Pratt & Whitney	6	55,044,000	9,904
11. Raytheon Co. Equip.	18	2,163,000	8,568
12. Northrop Corp.	9	6,896,000	6,506

13. Newport News Ship & Dry Dock	5	21,938,000	3,157
14. Westinghouse Electric	11	7,152,000	7,316
15. Boeing Seattle	9	28,726,000	9,441
16. Martin Marietta Aerospace (Denver)	11	7,097,000	5,000
17. Sanders Associates	8	1,725,000	3,021

Note 1. AVCO Aerostructures, Nashville, Tennessee is a suboffice of the Huntsville Branch. The Huntsville Branch shows a total of 2 positive reviews with a dollar value of $71,000. These 2 reviews may be AVCO or they may be some other company.

Note 2. Emerson Electric, St. Louis, Missouri is a suboffice of the St. Louis Branch. The St. Louis Branch shows a total of 6 positive reviews with a dollar value of $6,199,000. These 6 reviews may be Emerson Electric or they may be some other company.

Contractors 1 through 6, (Category 3 type contractors), above, were identified by DCAA as the contractors with the poorest records of P.L. 87-653 compliance. DCAA statistics indicate that (i) AVCO may have had a maximum of 2 findings valued at $71,000, (ii) Gould had 1 finding valued at $377,000, and (iii) Lima Tank Plant did not have any findings. Also only 752 hours of audit were expended at Gould during the past 2 and a half years and 234 hours of audit were expended at the Lima Tank Plant. These statistics do not appear to indicate serious problems. Would you agree with DCAA that these are problem contractors? If they are problem contractors, why is so little audit effort being expended on them?

Answer: Based on the information you cite, I do not agree with DCAA.

Question 4b: Contractors 7 through 17 were not identified by DCAA as contractors with poor records of P.L. 87-653 compliance; yet, DCAA statistics for the last 2 and a half years indicate that they should have been. These 11 contractors have numerous instances of defective pricing valued in the millions of dollars. Also, a substantial number of hours of audit have been expended on these 11 contractors. Please assess DCAA's judgement that these contractors do not have poor records of compliance with P.L. 87-653 and did not require identification as such to the Committee on Governmental Affairs.

Answer: Based on the information you cited, I would disagree with DCAA's judgement.

Question 4c: We understood that DCAA classifies contractors based on audit experience at Category 1 - least likely to have defective pricing, Category 2 - moderately likely and Category 3 - most likely. Can you explain why DCAA's system of categorizing contractors resulted in classifying contractors 1, 2 and 4 as Category 3 and contractors 7 through 17 as Category 2. It would seem that contractors 1, 2 and 4 would be better classified as Category 2 and most if not all contractors 7 through 17 would be better classified as Category 3.

Answer: I do not understand DCAA's basis for classifying these contractors. Your conclusions appear to be more accurate, based on the data you cited.

Question 4d: Have you or do you intend to issue any contract audit policy on the matter discussed above? If so, state what the policy would be.

Answer: I have not issued any audit policy on this matter because I only recently became aware of the problem. It was only recently determined that my office is responsible for contract audit policy. I plan to develop audit policy based on the results of these hearings and any followup efforts which may be necessary.

Question 5: DCAM 12-705(c)(4) requires DCAA field audit offices to report to Headquarters cases in which the amount of DCAA's recommended price adjustment due to defective pricing was not sustained by the contracting officer, and the auditor and contracting officer were unable to agree on the basis for the reinstatement. In response to our request, DCAA advised that only one such report has been received by Headquarters during the past 8 years. In that 8-year period, DCAA has issued 1,349 defective pricing reports. It seems very unlikely that DCAA auditors would be in agreement with contracting officers in 1,348 cases out of 1,349 during the past 8 years. It also would seem that DCAA management, at all levels, would be curious why no reports were being issued and ascertain the reason why. Please comment on this matter.

Answer: It appears that contract auditors are reluctant to report differences of opinion to DCAA Headquarters. It also appears that DCAA management is reluctant to encourage the practice of elevating differences of opinion for resolution.

Question 6a: The Armed Services Board of Contract Appeals (ASBCA) has altered its positions on defective pricing cases over the years. For example, at one time the ASBCA generally took the position that the effect of any defective cost data was a dollar for dollar increase in the contracting price. Now it appears that the cumulative effect of the rulings of the ASBCA are making it virtually impossible for the Department of Defense (DoD) to fully sustain the amounts of defective pricing reported by DCAA. ASBCA rulings on burden of proof, absence of contractor's certificate, natural and probable consequences, reliance upon data, setoffs, significance, submission versus availability of data, etc. are all limiting requirements established by the ASBCA which are not to be found in P.L. 87-653. Consequently, it appears that many DoD personnel believe that regardless of the validity of the DoD position it is better to settle with the contractor for amounts less than they believe DoD is entitled. If they don't, the contractor will appeal to the ASBCA where it is almost certain that the decision will be in favor of the contractor. Do you generally concur with the above assessment of the effect of the ASBCA's decision?

Answer: Yes. Our field visits indicate that this type of thing happens at many of the sites visited.

Question 6b: Do you believe the ASBCA decisions have influenced DCAA auditors' defective pricing audits? For example, would some instances of defective pricing reported and sustained in the late 1960s and early 1970s not be reported today because DCAA knows it could not be sustained today?

Answer: Although I am not aware of any specific cases, I believe that DCAA limits the scope of its reviews to some extent based on landmark ASBCA decisions. I will work into this matter and consider revising policy, if necessary.

Question 6c: Do you know whether DCAA has had to revise its guidance to its auditors because of ASBCA decisions? If so, elaborate.

Answer: I am not aware of any revisions directly attributable to ASBCA decisions.

Question 6d: Do you have any contract audit policy or oversight initiatives started or planned in this area?

Answer: No, but I will look into this matter.

Question 7a: On April 30, 1981 the Deputy Secretary of Defense issued a memorandum whose subject was "Improving the Acquisition Process." It contains a number of recommendations commonly referred to as "The Carlucci Initiatives." Recommendation 10 dealt with changing 10 USC 2304 so that a contract or revision thereto would have to be at least $500,000 instead of the then existing threshold of $100,000 to be subject to P.L. 87-653. The recommendation stated "raise threshold for contractor costing data from $100K to $500K to accommodate inflation and reflect current auditing procedures (paperwork load is such that only data for contracts over $500K is actually audited today)". On June 3, 1981 the Under Secretary of Defense for Research and

Engineering testified before the Legislative and Security Subcommittee of the Committee on Government Operations, First Session on H.R. 3519 supporting a change to raise the threshold. Did the Deputy Secretary, Under Secretary of Defense for Research and Engineering or other initiators of Recommendation 10 ask you if DCAA was auditing contractors pricing proposals under $500,000? If so, who asked you and what was your response?

Answer: I was not asked, Mr. Chairman.

Question 7c: If DCAA was auditing contractors' pricing proposals under $500,000 about how many proposals were audited during 1981?

Answer: About 15,000.

Question 7d: Would you support legislation to lower the threshold to $100,000?

Answer: I strongly support lowering the threshold to $100,000.

Question 8a: DAR 3-801.5(b)(1) and (2) provide policy relating to when contracting officers shall request field pricing support reports (which includes an audit report from DCAA). For some time this policy provided that reports were required for all firm fixed price proposals over $100,000, all fixed price incentive proposals over $250,000 and all cost reimbursement type proposals over $250,000. On December 27, 1982 this policy was changed to raise the threshold for requiring audit reports to $500,000 for all pricing proposals regardless of type. Did the Under Secretary of Defense for Research and Engineering who has responsibility for this policy ask you for your views on raising the audit report threshold requirement to $500,000 for all pricing proposals? If so, who asked you and what was your response?

Answer: I was not asked, Mr. Chairman.

Question 8b: If you were not asked about raising the audit report threshold requirement to $500,000 for all pricing proposals, did you advise the Under Secretary of Defense for Research and Engineering of your views on raising the threshold? If so, how, when and to whom was this information communicated? If in writing please provide copy.

Answer: Mr. Sherick expressed his concern about the proposed change to the USDR&E by memorandum dated January 4, 1982. I will submit a copy of the memorandum (attached) to record.

Question 8b: If you were not asked about raising the audit report threshold requirement to $500,000 for all pricing proposals, did you advise the Under Secretary of Defense for Research and Engineering of your views on raising the threshold?

If so, how, when and to whom was this information communicated? If in writing please provide copy.

Answer: Mr. Sherick expressed his concern about the proposed change to the USDR&E by memorandum dated January 4, 1982. I will submit a copy of the memorandum (attached) to record.

Question 8c: Do you know how many dollars of hard cost savings resulted from the audit of (i) firm fixed price proposals under $500,000 and (ii) fixed price incentive proposals under $500,000 for 1981 and also for 1982? Finally, what is the ratio of cost saved to DCAA's cost of performance?

Answer: During FY 1981 DCAA reported cost savings of about $160 million from audits of firm fixed-price proposals under $500,000. Similar savings were reported for fixed-price incentive proposals. These savings were achieved with the expenditure of between $7 and $8 million in audit resources (roughly $20 saved for every $1 of effort). I do not yet have statistics from DCAA for FY 1982.

Question 8d: Do you believe the savings attained in the past warrant lowering the thresholds in DAR 3-801.5(b)(1) and (2) back to $100,000 for firm fixed price proposals and $250,000 for fixed price incentive proposals? If so, elaborate.

Answer: I believe the thresholds should be lowered. I support Senator Levin's Amendment to the "Competition in Contracting Act" that would lower the certification threshold, and I will push for a similar change in the DAR threshold for audit.

Question 9: DoD Directive 7640.2 (formerly 5000.42) establishes DoD policy for the timely resolution and disposition of significant contract audit reports. The Directive requires that DoD components track and report on the status of all defective pricing reports from the date of receipt through final disposition. If the contracting officer disagrees in the auditor's recommendation for a downward price adjustment due to alleged defective pricing, the Directive requires that the disagreement be brought promptly to the attention of a designated independent senior acquisition official or board for review. The review official or board is required to provide to the contracting officer, with a copy to the contract auditor, a clear, written recommendation concerning the issue in question. The Directive also requires that the contracting officer provide written feedback to the auditor on the final disposition of the audit report. It is understood that procurement officials have vigorously resisted the issuance and implementation of the contract audit followup directive in the past. Are they still fighting it? If so, what are they doing to frustrate its implementation, and what actions have you taken or will you take to overcome this resistance?

Answer: Some procurement officials have been less than enthusiastic about implementing the Directive. I am not aware, however, of any attempts to "frustrate" its implementation. The components are understandably concerned about their workload. I am doing all that I can to ensure that they fully understand the Directive's requirements. I am also making sure they understand that I will not leave them alone until I am satisfied that the Directive is fully implemented. Secretary Weinberger has fully supported all of our efforts.

Question 10: The contract audit followup status reports required by the DoD directives mentioned in 9 above for the 6-month period ended September 30, 1982 identified 145 defective pricing cases on contracts awarded to 45 separate contractors where contracting officers are experiencing problems in disposing of the cases. Please prepare a summary identifying the 10 contractors with the largest dollar value of cases outstanding. For each of the 10 contractors list their name, location, number of cases and total dollar value of the cases. Also, include a line item for the other 35 contractors listing the total number of cases and total dollar value of the cases.

Answer: I will submit the (attached) list for the record.

Contractor/Location	No. of Reports	Total Questioned
General Dynamics Fort Worth, TX	2	$52,912,000
Grumman Aerospace Corp. Bethpage, NY	32	29,574,000
McDonnell Douglas Corp. St. Louis, MO	26	25,934,000
Pratt & Whitney Aircraft East Hartford, CT	3	22,631,000
Newport News Shipbuilding Newport News, VA	2	9,993,000
Fairchild Republic Farmingdale, NY	3	8,134,000
Chrysler Corp. Detroit, MI	4	8,007,000
Lockheed Marietta, GA	6	7,513,000
Sperry Rand Great Neck, NY	6	6,998,000
FMC Corp. Minneapolis, MN	3	3,907,000
All Others	58	32,070,000
Total	145	$207,743,000

Chairman Roth. At this time, I would like to call the Honorable Harris J. Andrews, Chairman, Armed Services Board of Contract Appeals, and Mr. Donald J. Kinlin, senior trial attorney, U.S. Air Force.

Gentlemen, we are happy to welcome both of you here today.

As I indicated earlier, I would appreciate your keeping your opening remarks to 10 minutes but your full statement will be included in the record as if read.

TESTIMONY OF HARRIS J. ANDREWS, JR., CHAIRMAN, ARMED SERVICES BOARD OF CONTRACT APPEALS, ALEXANDRIA, VA., AND, DONALD J. KINLIN, SENIOR TRIAL ATTORNEY, U.S. AIR FORCE, WRIGHT-PATTERSON AIR FORCE BASE, OHIO

Mr. Andrews. Thank you, Mr. Chairman.

In my written statement, I express some concerns with one or two preliminary questions. I was afraid I would be called upon to justify the decisions of the Board of Contract Appeals.

I understand now that is not the case. So I wouldn't like to pursue that.

I would like to state briefly the functions and authority, the nature of the Board of Contract Appeals. The ASBCA is established by charter of the Department of Defense signed by the Secretary of Defense and the Secretaries of the Military Departments. We are authorized to decide in behalf of the Secretaries contract appeals to the same extent that they themselves would be able to decide them.

Our authority derives from the Contracts Disputes Act of 1978 which was one of the children of this committee and the Judiciary Committee combined. We are established as a quasi-judicial forum. We have maintained independence from the Department. And we are to decide our cases to the best of our ability on the facts, the law, the regulations and the contract provisions.

I will try to address some of the questions that have been put to me. Two of these questions are related. I was asked what can the Government do to overcome the weaknesses in defective pricing cases and how I relate the ability of Government personnel to prepare and present their cases to the contracting personnel. The weaknesses we have seen in most of the past cases, where there were weaknesses, is in a lack of understating that most cases are decided on the facts of that particular case and not on some general principle. And this can be overcome by an understanding of counsel and the witnesses working together of what must be shown in order to present an effective pricing case.

Again they have to submit the facts to support their case. If the contractor is to win, he must do the same thing. While we imposed a presumption that the natural and probable consequences of defective pricing is an overstatement of the contract price, when the contractor is able to overcome this presumption, the Government must prove its case. I have listened to the prior witnesses and to the present procedures which have been established for coordination in negotiations of contracts and the records that are to be kept, by the auditors, by the contracting officers, negotiators and so forth. I think if that procedure had been in effect in the past years the Government would have been in a much better position to present its case in the defective pricing area appeals. This will go a long way to overcome the problem.

I am also persuaded that the ability of the Government personnel to present their cases compares favorably with that of the contractor personnel and the private bar. I know that DOD has conducted an extensive program of trying to educate, upgrade and qualify their contracting officers and contract negotiators. I know that the DCAA has had a program of seminars and other methods to advise the auditors of claims and disputes procedures and what it means when a case goes to the ASBCA. I believe that these programs have been successful.

The senior trial attorneys in the Government who are presenting these cases are as good and as well qualified as any attorneys in the private bar in these matters. Some less experienced Government attorneys have a disadvantage against seasoned private lawyers. It is difficult for the trial offices to retain their excellent young attorneys because they can get more money in the big law firms or with the contracting organizations.

I was asked what the ASBCA has done and what it can do to speed up settlement in defective prices cases. The ASBCA attempts to dispose of all of its cases promptly. This has become very difficult recently. In the past several years a number of new cases has risen astronomically. We now have over 1,700 appeals on our docket. That is almost unmanageable with our present facilities and personnel.

I have conducted studies to determine if our procedures should be changed, what kinds of numbers of personnel may be required to get our work more current.

One of the problems is that the Contract Disputes Acts mandates expedited and accelerated procedures with time limits for disposition. By giving preference to the smaller cases, the larger cases suffer. Discovery in cost type cases including defective pricing data is generally extensive. Each side wants to know when they get to the Board everything that the other side knows about the case. The purpose of discovery is to disclose the case but very time consuming. We attempt to speed up things by pretrial procedures and orders and by case tracking methods and we will consider changing our rules, our procedures, whatever we can do to get back on track.

In this connection, I looked over the pending cases to see if we had any very old defective pricing data cases. I found that we did have three but all of them are now on track. So at least to the extent that they are suffering, they are suffering along with all of the other cases.

I was asked the question of whether penalties should be assessed. I would normally think that penalties are too difficult to enforce to be important. We have the False Claims Act that is available here, but it isn't very often used. We have the fraud and misrepresentation provisions of the Contract Disputes Act. If there has been a case decided under that one I haven't seen a report of it.

I don't have the statistics and I didn't have those I heard here today to help or make any kind of judgment. So I have no expression of opinion as to whether a penalty should be assessed. If there is to be a penalty, however, I have a recommendation as to the nature. I think it should be stated as a minimum recovery by the Government under the Truth-in-Negotiations Act if it is to be imposed.

That would permit the entire proceeding to take place at one time, with the contracting officer, then the ASBCA or the U.S. Claims Court. From our limited view at the ASBCA and it is limited because our cases are not too many, I had the impression that the Contract Disputes Act was working as it is now written. From some of the statistics I have heard today I might have to rethink that but I haven't had them long enough to do so.

The ASBCA does not specifically report to DOD on the shortcomings of particular cases nor can it properly do so. Our decisions are made by written opinions and these are widely distributed throughout the Government and elsewhere. They are all published by Commerce Clearing House and synopses of selected cases by a vast number of other legal and trade publications including Government journals.

We also, members of the board and staff, talk to groups of people about board procedures and how to present a case to the board and that kind of thing regularly to government, private, mixed groups, attorneys, and contracting officers and administrators.

There has been an increase in the number of defective pricing data cases docketed by the ASBCA in recent years. Beginning in fiscal year 1981, the numbers increased substantially over what they had been for the last several years before that. But they are still relatively small. So it is still difficult for me to draw any general conclusions on numbers. I have no information, or had very little until this morning, about the number of defective pricing data claims that do not reach the board.

From the available information I would surmise that there has been some deterioration in the contractors' presentation of cost and pricing data. It is obvious that there has been an increased emphasis by DOD contract and auditor personnel in enforcement of the act. Also there has been a very substantial increase in the value of these claims that I have noticed in the last couple of years. These claims are far higher than anything before.

Back in the early days, $10,000, $12,000 was a fairly sizable one. Now it is in the millions.

Most of the cases docketed are settled by the parties after discovery and other pretrial procedures, with the aid of experienced trial counsel. This would not indicate to me that contractors think they are more successful in adjudicating with the ASBCA than in negotiating with the contracting officer. To the contrary it shows once contractors learn all the facts of the case they are most often willing to admit liability and settle. Otherwise they would insist upon a hearing by the board.

The ABSCA received four pricing appeals in fiscal year 1980, 22 in fiscal year 1981, 20 in fiscal year 1982. During that time we disposed of 38 defective pricing cases, of which 2 were decided, 31 were dismissed following settlement, and 5 were dismissed for other reasons. One of the decided cases was in favor of the contractor and the Government recovered none of the $139,181 in claims. The other was decided for the Government and in the amount requested, $130,561.

During fiscal year 1980 to 1982, one appeal was dismissed for failure of the contractor to appeal within the period required by the Contracts Disputes Act, one was dismissed with prejudice for the contractor's failure to prosecute the appeal, no others were rejected, not accepted or referred back to the DOD.

Mr. Chairman, I will be happy to answer any questions.

Chairman ROTH. Thank you, Judge Andrews.

Before we proceed with the questions we will invite Mr. Kinlin, who is the senior trial attorney for the U.S. Air Force at Wright-Patterson Air Force Base.

Mr. Kinlin, if you would summarize and keep your comments if you could to 10 minutes.

Mr. KINLIN. Thank you, Mr. Chairman.

Mr. Chairman, members of the committee.

I am Don Kinlin and I am an Air Force trial attorney. Defective pricing litigation is one of the areas in which I specialize, so I certainly appreciate this opportunity to comment on the Truth-in-Negotiations Act. However, you should know that I am not here as an official representative of the Department of Defense or the Air Force but rather as an individual to give you my own personal opinions.

First of all, Mr. Chairman, I would like to make clear to you that, in my opinion, the Armed Services Board of Contract Appeals is highly respected by both the Government trial attorneys and by the private bar for its acknowledged expertise in Government contracts and it has done an outstanding job in deciding the wide variety and multitude of cases that come before it.

My primary disagreement with the Board is the way in which it has been interpreting the Truth-in-Negotiations Act.

I understand the Truth-in-Negotiations Act to require contractors to completely disclose their most accurate, complete, and current cost or pricing information to the Government negotiators.

Congress intended the Government negotiators to have available to them the same cost or pricing data available to the contractor's negotiators.

After the act became effective, December 1, 1962, the Government won a series of cases at the ASBCA and court of claims.

As a rule, these cases strictly interpreted the act. For example, in American Bosch Arma Corp., ASBCA No. 10305, 65-2 BCA 5280, the Board adopted the "natural and probable consequence" presumption that there is a dollar-for-dollar reduction in the contract price equal to the amount of the defective pricing.

This presumption was affirmed by the court of claims in *Sylvania Electric Products, Inc.,* v. *United States* (1973) and the presumption is essential for the effective enforcement of the act. In recognition of its importance, it was also adopted by the Armed Services Procurement Regulation, at section 3-807.10(A)(2).

However, in recent years, the pendulum has swung in the other direction. Now, although the Government can show nondisclosure of the contractor's data, the contractor's nondisclosure is excused for a variety of reasons. As a result, the effectiveness of the act has been limited by the case law interpreting it.

For example, in a recent case, the ASBCA excused the contractor's nondisclosure because it found that the contracting officer should have known about the data. Although this case was reversed by a 3-to-2 vote on reconsideration by the ASBCA, other cases have excused the contractor's nondisclosure; one, because the data were not "reasonably available" to the contractor at the time of negotiations; two, because the Government did not show that the nondisclosure led to an overpricing of the contract; three, because the contractor was in a "superior" bargaining position; four, because the contractor was a sole source supplier; five, because the contractor negotiated a "bottom-line" number; six, because the contracting officer, supposedly, did not rely on the inaccurate data submitted by the contractor——

Chairman ROTH. Could I interrupt to say that there was one decision in which that remedy was refused because it was a sole source contract, is that right?

Mr. KINLIN. Yes, Senator.

Essentially what they said, because the contractor was a sole source contractor, the Board decided the contractor would not negotiate a higher price regardless of the cost of pricing data disclosed, actually not regardless of that disclosed but despite the cost and pricing data that was not disclosed.

The Board found the contractor would not have negotiated a higher price in any event.

Chairman ROTH. Is that a recent case?

Mr. KINLIN. I don't recall the date off hand.

Chairman ROTH. If you carried that to an extreme, wouldn't that rule out any remedy in most of these cases?

Mr. KINLIN. It would rule out a remedy in a lot of the cases where the contractor was a sole source supplier, yes, Senator.

Chairman ROTH. Yet the purpose of the law was to provide some protection to the Government that is was getting a fair price where there is no competition.

So that would be, if I understand you, defeating the intent of the law?

Mr. KINLIN. It certainly would frustrate it in my opinion, Senator.

Chairman ROTH. Please proceed.

Mr. KINLIN. And because there was no basis for believing the contractor would have negotiated a further reduction to its proposed price.

In another case, the Board said that a mere showing that a disclosure was not made during negotiations, to the Government negotiators, did not establish that a disclosure was not made at some earlier date, to some other Government personnel who evaluated and audited the proposal prior to the negotiations.

Although the ASBCA originally denied offsets to defective pricing—1967—the court of claims overruled it—1969—and decided offsets should be allowed up to the amount of the defective pricing—*Cutler-Hammer.*

In my opinion, if Congress is to achieve the results originally intended when it passed the Act, some changes are needed to Public Law 87–653 to reverse the trend in the case law interpreting the act. I believe the following would accomplish this goal.

Chairman ROTH. Would you highlight some of the more important recommendations?

Mr. **Kinlin**. Yes. I would. My primary one is not to allow offsets which essentially is when the Board finds that the contractor underprices the contract for whatever reason, unless the Government can show and prove that the contractor consciously did not intend to exclude that data, then it is allowed to offset the amount of the defective pricing up to that specific amount.

In my experience, we don't have one defective pricing case in which the contractor has not come in with an amount of offsets which clearly exceed the amount of the defective pricing.

So this is an area that in essence would clearly frustrate the purpose of the act and it concerns us because it is very hard for us to prove that they consciously decided to exclude these costs in their proposal.

One of the other areas I want to mention, is to ask the Congress not to excuse contractors that contract with the U.S. Government for sales to foreign governments from the requirement to fully disclose their known data.

There has been an issue raised on contracts for sales to foreign governments, whether the contract requires providing cost and pricing data and is subject to the Truth-in-Negotiations Act.

I would like to have a clear statement from the Congress that they definitely intended that requirement for foreign military sales contracts.

Chairman **Roth**. I take it from what you are saying there is no consistent practice now?

Mr. **Kinlin**. Frankly, Senator, it is a problem that developed rather recently. We always thought that the statute was clear and that it would be required but because of some questions that have come up recently, I would like to see it clarified.

One of the things that I suggest you may want to consider is establishing another forum to decide the defective pricing allegations by the Government. This would be in accounting court, or even a special division within the Armed Services Board of Contract Appeals, composed of attorneys who are also accountants.

I would also mention, as an aside to the comment you made earlier, Senator, as to DCAA. I have never in my experience noticed any effort on the part of DCAA to avoid offending the acquisition community when they took a position on defective pricing.

DCAA has never been reticent in hurting anyone else's feelings when they are pushing defective pricing.

I see DCAA as the real focal point in the thrust and effort against defective pricing.

Another comment was made by Senator Cohen, and I would like to comment on that. That was pertaining to the lack of certification.

I realize that there are Board decisions that say that unless there is a certificate, they will not find defective pricing.

I understand the requirements of the statute which require certificates.

I have given talks before the American Bar Association, and various other forums, and I have stated publicly that if we find a case where there is no certificate and we are convinced there is defective pricing, we intend to take it to the Board and if the Board still holds to its rule that a certificate is required, then we intend to challenge that in the court of appeals for the Federal circuit. So that how we feel about the lack of a certificate, we believe it is required by the statute, and we intend to enforce that requirement.

In conclusion, Senator, I can assure you that if you give those of us in the Government charged with enforcing the act the necessary weapons we will enforce your original intent to the maximum extent practicable.

All I am asking is for you to help us to help you.

Thank you.

Chairman ROTH. Thank you.

I want to thank both of you gentlemen for being here today and giving us your comments on this most important problem.

Mr. Kinlin, do you believe that ASBCA decisions have encouraged contractors to appeal contracting officer's decisions which were not favorable to the contractors?

Mr. KINLIN. Yes, I do, because I believe the decisions, as I stated in my opinion, have liberally interpreted the intent of the act.

I believe that the contractors today are armed with more arguments than they previously had as to the list of excuses available to them.

Again, as I stated in my testimony, the burden on the Government is very heavy under the Truth-in-Negotiations Act as it has been interpreted.

On the other hand, I have no doubt that if we can carry that burden, the Armed Services Board of Contract Appeals would uphold the Government. But I do believe that the decisions as they stand today have encouraged the contractors to challenge us on every front.

I expect the number of disputes to increase.

Chairman ROTH. Judge Andrews, I don't know whether you care to comment or not on that question.

Mr. ANDREWS. Only, Senator, to the extent as I said a few minutes ago, the cases are decided generally on the facts of that particular case.

If the Government doesn't bring us a good factual case and doesn't win its case, there is an old truism that bad facts may make some bad laws.

But most of these cases that he has been talking about are those in which the accumulative effect of the evidence in the case failed to show that the contract price was overstated by defective pricing.

That is the requirement of the statute.

Chairman ROTH. Let me go back if I might to the point that I think you made, Mr. Kinlin, that earlier the position of the ASBCA was that the effect of any defective cost data was a dollar for dollar increase in the contract price. It is your thinking that subsequent decisions have eroded that basic concept. How is that possible?

As a layman, if a contract shows or the cost data shows that there was an error of a dollar, how can a return less than a dollar be accepted?

Mr. KINLIN. From one layman to another, Senator, I believe that the rule is still there. There is still the dollar for dollar presumption and the Board would apply it in certain cases. The problem becomes that we have a growing list of what I term excuses to not having the dollar for dollar presumption. In other words, the Government can still prove nondisclosure where the contractor did not disclose the more recent cost and pricing data. Yet, despite that fact, the nondisclosure can be excused for certain reasons.

Chairman **Roth**. May I ask you there. If it is excused, I assume that there is no collection?

Mr. **Kinlin**. There is no collection.

Chairman **Roth**. But it is still the basic rule that there are—let me ask you this question. The decisions don't suggest that where there is inadequate or defective prices that something less than a dollar should not be collected. It is just that there are more exceptions than before; exceptions have begun to swallow the rule, is that right?

Mr. **Kinlin**. The rule is there for whatever it is worth.

Chairman **Roth**. Would you care to comment, Judge Andrews?

Mr. **Andrews**. Senator, as I recall the old cases, the only ones that where the dollar for dollar has ever been allowed by either the board or by the Court of Claims are those in which there was no evidence to show that it should be reduced by a certain amount. If there is evidence that shows, for instance, some of these cases may have half a dozen items but only one of them clearly didn't effect the price. So you don't get the whole amount. That is all.

Chairman **Roth**. Mr. Kinlin, do you believe that the ASBCA decisions have discouraged contracting officers from vigorously pursuing settlements with contractors for full recovery because they feel that the contractors will appeal to the ASBCA where the contracting officers' position will not be sustained?

Mr. **Kinlin**. I believe that is one of the reasons, Senator, that the contracting officers don't try to fully enforce it. There are several other reasons. Let me go to them first.

One is that the contracting officers have full-time jobs and they are probably working more than 40 hours a week at those full-time jobs. So whatever hours they have to put into the defective pricing cases, these hours are over and above that full-time job. The other reason is that we have audit reports. Everybody that is involved in this business will tell you that they are not always 100 percent complete and accurate themselves and that sometimes we, by we I mean the contracting officers and myself, disagree with some of the underlying assumptions made by the auditors.

I had one particular case where DCAA and GAO both did an audit, and they came up with different figures. So a lot of times there are disagreements on the underlying assumptions. Then you come down to the point where you have to advise the contracting officer on the probability of winning or sustaining the government case at the ASBCA, not only on what the auditors findings are, but also on the case law as far as we understand it today, and, in particular, the offsets proposed by the contractor.

I have a case that is currently pending, where the contractor has admitted that it defectively priced a contract, but says it should still be excused because it has so many offsets involved in it. When I look at all the lists of the excuses and at the proposed offsets by the contractor which happens in every single case, then I have to advise the contracting officer that we probably are better off trying to negotiate settlement in this case than taking it up to the ASBCA. Again, I don't want to create the perception that the contractor says, "I will take you up to the ASBCA where I am going to prevail" because they find the ASBCA a simple forum to prevail. That is not the concept I am trying to get across.

What I am trying to say is the contractor will appeal because of the way the law is being interpreted today. It has a lot of excuses it can present and it has a lot of offsets it can propose. Therefore, the contractor feels that it does have high chances of success in litigation.

Chairman ROTH. To what extent do you think supplying defective pricing data is deliberate and to what extent do you think it is inherent in the circumstances? It is hard for the layman to understand why every year there should be something like $500,000,000 of defective pricing. You are talking about $70 billion to $80 billion of contracts. Is it inherent in the situation or do you think in many cases it is deliberate?

Mr. KINLIN. I don't think it is deliberate in most cases although we are certainly being realistic. In a small percentage of the cases it is deliberate. But in most of the cases it is not deliberate.

Chairman ROTH. How does it occur?

Mr. KINLIN. I would give you some examples I am aware of. I would say the contractors are negligent in a lot of instances in their defective pricing because they don't update their data. There have been DCAA audits on a contractor, making suggestions as to how the contractor can improve its pricing proposal and its accounting systems and the contractors don't adopt our suggestions for whatever reasons.

Chairman ROTH. Let me ask you this, when it comes to the negotiation of the contract, why isn't it incumbent upon the contracting officer to ask for adequate information?

Mr. KINLIN. As far as I know, Senator, in every instance the contracting officer must prior to handshakes, request the most complete and accurate data from the contractor. The contractor, in every instance that I am aware of, also states that it has been provided. It is after the fact that we find that the most current and updated data was not provided, and, again, I say it is because the contractors have been negligent within their accounting system in not providing that type of data to their own negotiators.

It happens in a lot of instances, particularly in these large procurements, where the procurements are so massive, there are thousands and thousands of line items involved, and, frankly, unless you do have a good accounting system, it is awfully hard to keep up with the most current data. So even though you have buyers out there getting updates every day, they don't forward the updates up to their negotiators, and sometimes several months pass before the contractor's negotiators may even be aware of the updated data. So again it is not deliberate.

But they are definitely negligent within the system in not providng that kind of data to their own negotiators.

Chairman ROTH. Gentlemen, I appreciate both of your being here today. It has been most helpful. If we have additional questions, we will contact you at a later time.

[The prepared statements of Mr. Andrews and Mr. Kinlin, with attachments, follows:]

PREPARED STATEMENT OF HARRIS J. ANDREWS, JR.

The Armed Services Board of Contract Appeals is established by charter and authority of the Contract Disputes Act of 1978. The duty of its members is to decide appeals on the record of the appeal to the best of their knowledge and ability in accordance with applicable contract provisions and in accordance with law and regulations pertinent thereto.

As explained in the Joint Report of this Committee and the Judiciary Committee of August 15, 1978, on S. 3178, which became the Contract Disputes Act; the provisions of the Act were designed, among other things, to help induce resolution of more contract disputes by negotiation prior to litigation. Key elements of the system of disputes resolution are the boards of contract appeals, acting as quasi-judicial forums and strengthened by additional safeguards to assure objectivity and independence.

Members of the board are apointed to serve in the same manner as administrative law judges, to be appointed strictly on merit. In conducting proceedings and deciding cases, they are not subject to direction and control by procuring agency management officials.

The Congress would defeat its own purpose in establishing special courts and quasi-judicial adjudicatory forums, if it calls them into account for particular decision. Then the Congress would be back into the adjudication of individual claims and disputes, the volume of which is far beyond its time and resources.

I do not believe, of course, that this Committee would attempt to unduly influence the decisions of the ASBCA. But some preliminary questions are disturbing, particularly the first one, which is a statement or misstatement of the Act and the decisions of the ASBCA. I cannot properly discuss or debate the correctness of particular cases.

Most appeals are decided on the facts of the case. The most the Government can do to improve its presentation in defective pricing data cases is to disclose all relevant facts.

The ASBCA attempts to dispose of all of its cases in an expeditious manner. The sharp input of new cases and backlog of over 1,700 appeals makes this nearly impossible. The Contract Disputes Act provides for expedited and accelerated procedures for smaller claims with relatively short time limits for disposition. By giving them priority, the larger cases are delayed. We have attempted methods and will try others to speed up cases disposition.

The ability of Government personnel to prepare and present defective pricing cases compares favorably with the ability of contractor personnel. The Goverment's procurement personnel and auditors are competent and capable. Its senior trial attorneys are as competent as those in the private bar. The only apparent weakness is in some less experienced attorneys.

The helpfulness of penalties in defective pricing cases is debatable. Penalties of the False Claims Act are available but seldom used. The limited number of defective pricing cases brought to the ASBCA does not give me enough perspective to recommend for or against a penalty. I do recommend that if a penalty is imposed it be in the form of a minimum recovery under the Truth in Negotiations Act to avoid the necessity for a separate proceeding.

From the limited perspective of the ASBCA, the Truth in Negotiations Act is effective as written. Relatively few cases were presented during Fiscal Years 1975-1980. There has been some increase recently, but the numbers are very small compared to the thousands of contracts subject to the Act.

The ASBCA advises DoD of shortcomings of its officials only through its published opinions. Members also talk and lecture to Government, and contractor attorneys, contract administrators, and auditors on the disputes process and board proceedings.

The ASBCA has no information on the number of defective pricing cases settled which do not reach us. There has been an increase in those docketed in the past two fiscal years, but the numbers are too small to conclude whether the quality of contractors' proposals has deteriorated. The very small number which contractors bring to trial does not indicate that contractors think they are more successful with the ASBCA than with contracting officers.

During Fiscal Years 1980-1982 the ASBCA disposed of 38 defective pricing cases, two by decision, 31 following settlement, one each for late appeal and failure to prosecute, and 3 were dismissed at the request of the parties. These numbers indicate that when contractors learn all of the facts through discovery and other pre-trial procedures, they are willing to admit liability and settle.

The ASBCA received four appeals from defective pricing clams in FY 1980, 22 in FY 1981, 20 in FY 1982, and 10 in the first half of FY 1983.

Two decisions were issued in FY's 1980-1982. In one in which $139,181.11 was claimed was decided for the contractor. The other in which the Government claimed $130,561 was decided for the Government in the amount requested.

During FY's 1980-1982, one appeal was dismissed for untimeliness, and one for failure of the contractor to prosecute the appeal. No others were rejected, not accepted, or referred back to DoD.

The regulations are sometimes revised to comport with ASBCA decisions. When the responsible procurement officials think the decisions are wrong, they can, and do, revise the regulations and contract clauses to be applied in the future. The Government now has the right, under the Contract Disputes Act, to appeal adverse decisions of the ASBCA to the U.S. Court of Appeals for the Federal Circuit.

PREPARED STATEMENT OF DONALD J. KINLIN

I. Introduction

Mr. Chairman and Members of the Committee, I am Don Kinlin and I am an Air Force Trial Attorney. Defective pricing litigation is one of the areas in which I specialize, so I certainly appreciate this opportunity to comment on the Truth in Negotiations Act.

Although I am an Air Force Trial Attorney, I am not here today as an official representative of the Department of Defense or the Department of the Air Force, nor have I been authorized to make any policy or official statements on their behalf. Therefore, my testimony will reflect only my own personal experiences and opinions. My objective is to assist you in understanding how the Truth in Negotiations Act is being interpreted by the Courts, the Boards of Contract Appeals, Government employees and Government contractors, and to offer my suggestions as to how the Act should be improved to assist the Government in enforcing the intent of Congress.

II. Truth in Negotiations Act - Congressional Intent

The Truth in Negotiations Act seeks to place the Government on an information parity or equal footing with contractors during price negotiations in order to avoid excessive prices and profits. To understand the intent of the Truth in Negotiations Act, one must understand that any analogy to the commercial negotiation of contracts is not valid unless the buyer can purchase only from one seller. The lack of competition eliminates incentive to cut costs and can lead to inflated prices. In addition, since the negotiation of the price in noncompetitive situations must be based upon projected costs, the seller is at a distinct advantage because he has far more insight into his cost projections and has control over the type and amount of cost information disclosed to the contracting officer.

In this setting the Honorable Carl Vinson, Chairman of the House Armed Services Committee, proposed a truth-telling requirement for incentive type contracts. H.R. Rep. No. 1797, 86th Congress 2d Sess. (1960); H.R. Rep. No. 1638, 87th Congress, 2d Sess. (1962). The Senate Committee generalized the application of the bill to all negotiated contracts. S. Rep. No. 1884, 87th Congress, 2d Sess. (1962).

The House considered H.R. 12572 on 24 June 1960 and it passed by a voice vote. 106 Cong. Rec. 14258 (1960). Mr. Vinson stated the purpose "is to bring negotiated procurement under more rigid legislative control," 106 Cong. Rec. 14256 (1960), and the report accompanying the bill stated the cost or pricing data certification requirement was one of the most important and useful provisions in the bill because it required complete disclosure in negotiation and an agreement to readjust the price for defective pricing. H.R. Rep. No. 1796, 86th Congress, 2d Sess. 5-6 (1960). Representative William H. Bates, in endorsing the bill, stated "No honest bargainer can object to it, it seems to me. It simply calls for truth in bargaining and paying. I think that it is not too much to expect and require." 106 Cong. Rec. 14258 (1960).

The issue rested for a year before the House Armed Services Committee reported out H.R. 5532. Mr. Vinson appeared before the

Senate Armed Services Committee on H.R. 5532 and stated that the contractor who disclosed all known facts would have nothing to fear, but the contractor who concealed information it possessed at the time it negotiated would have problems. Hearings on H.R. 5532 Before the Senate Committee on Armed Services, 87th Congress, 2d Sess. 25 (1962). Senator Symington stated, "we are trying to get as much truth as possible in negotiations." Hearings, supra, at 26.

The Senate passed an amended bill on 22 August and the House concurred on 28 August. The bill became law on 10 September and took effect on 1 December 1962. 108 Cong. Rec. 17351, 17920 (1962); Public Law 87-653, 10 U.S.C. §2306(f) (1962). By this law, Congress sought to insure reasonable pricing in negotiated contracts. Statutorily, this scheme is simple. With certain exceptions, contractors and subcontracters are required to furnish their most current, accurate and complete cost or pricing data, and, in addition, are required to certify to the best of their knowledge that the cost or pricing data submitted is current, accurate and complete.

Congress clearly intended that all known cost or pricing data be furnished to the Government. Congress futher intended that if that data are not accurate, complete and current, the Government has the (unilateral) right to revise the contract price to compensate it for the erroneous, incomplete or out-of-date information.

There is no indication whatsoever in the statute or legislative history that Congress intended exceptions (excuses) for not furnishing all known cost data, or that Congress intended to limit the Government's recovery by allowing setoffs.

III. Truth in Negotiations Act - Case Law

Case law has severely limited the applicability of the Truth in Negotiations Act and, at times, has frustrated the intent of the Act. Three areas in which case law has restricted enforcement of the Act are discussed below.

A. Furnishing of data.

The Act requires contractors to submit "cost or pricing data" and prescribes a contract revision adjusting the price:

> [T]he price to the Government,...shall be adjusted to exclude any significant sums by which it may be determined...that such price was increased because the contractor or any subcontractor required to furnish a certificate, furnished cost or pricing data which,...was inaccurate, incomplete, or noncurrent....

10 U.S.C. §2306(f); See DOD policy in Defense Acquisition Regulation (DAR) 3-807.3, 3-807.4, 3-807.5, 7-104.29, 7-104.41.

Furnishing data refers to all cost and pricing data available to the contractor. This data should be submitted in writing, or specifically identified in writing if actual submission is impracticable. DAR 3-807.3(a). Although the Court of Claims stated that merely making data available is not furnishing data within the intent of the Act, M-R-S Manufacturing Company v. United States, 492 F.2d 835 (Ct.Cl. 1974), the Armed Services Board of Contract Appeals (ASBCA), in Whittaker Corporation, Armed Services Board of Contract Appeals ASBCA No. 17267, 74-2 BCA ¶10,938, denied a refund under the Truth in Negotiations Act by adding the requirement that the Government must prove it had no knowledge of the data. The ASBCA stated that the Government burden of proof is not satisfied merely by showing that disclosure was not made during negotiations, and it went on to require that the Government prove the disclosure was not made to other Government personnel prior to the negotiations. This places a tremendous burden upon the Government because it has many echelons of employees in various agencies and departments who assist, but do not participate, directly or indirectly in the preparation of negotiating contracts.

In Universal Restoration, Inc., ASBCA No. 22833, 82-1 BCA ¶15,762 (9 Apr 82), the Government contended that the Appellant (a small business with expertise in restoration of historic buildings) failed to disclose its true overhead costs in pricing the basic contract and its several modifications. The Appellant had submitted a $65,000 price proposal which included an overhead rate of 115% and a profit allowance of 10% based upon direct labor costs. A time and materials contract was awarded to the Appellant for the amount of its proposal on 31 May 1974.

On 26 August 1974, the scope of work was enlarged and the contract price was increased to $250,000. During the period 31 December 1974 to 12 March 1975, additional work requirements were agreed to by the parties and each time the Appellant's proposal was accepted as submitted. On 12 March 1975, the parties agreed to additional work which increased the price by $1,335,000 (total contract price $1,984,800). Again, Appellant's proposal was accepted as submitted, including the 115% overhead rate.

On 23 September 1975, Appellant satisfactorily completed the contract. Appellant's 115% overhead rate was never questioned by any of the three contracting officers successively assigned to this contract.

The Appellant clearly did not disclose its actual overhead rate. A DCAA post-award audit found that if current overhead data had been furnished as of the date of each certification, the contracting officer would have negotiated a lower overhead rate which would have resulted in a $130,561 reduction in the contract price.

However, the ASBCA, in a 3 to 2 decision, found that these contracting officers did not rely on the Appellant's pricing data "as long as the price could be found to be reasonable," and therefore were not misled by its nondisclosure.

In essence, the Board said that the Government did not question or challenge whatever overhead rate the Appellant proposed, however defective, and so the Government was stuck with it. The Board held that the Appellant would accept nothing less than the overhead rate proposed, leaving the Government to take it or leave it. The Board said that the contracting officer *should have known* that the overhead rate decreases when the labor base expands. (There is no discussion as to the contracting officers' knowledge of Appellant's other work which would affect the labor base. *E.g.*, if Appellant's other work had decreased by the same amount as the increase on this contract, the overhead rate would have remained relatively constant. If Appellant's other work had decreased by more than the increase on this contract, the overhead rate would have increased. Conversely, if Appellant's other work had remained static or had increased, the overhead rate on this contract would have decreased.)

This case tells us that a contractor will not be liable for nondisclosure of its cost or pricing data if the Government *should have known* (constructive knowledge) about the data not disclosed. As the Board stated at the end of its opinion: "The Government may have won the battle [by proving nondisclosure] but it lost the war." This case also implies that a "take it or leave it" attitude by a contractor will allow it to thwart the clear intent of the Act. In my opinion, the Government needs a clearer statement of Congressional intent if it is to win the fight against defective pricing; otherwise, such decisions will only serve to dampen the Government's efforts to assert price reductions and only reinforce the Government's efforts to negotiate settlements (peace) in these disputes as being in the Government's best interests.

Administrative Judge Monroe E. Freeman, Jr., (dissenting) stated:

> The majority finds that the contracting officers *ought to have known* that appellant's overhead rate was declining because the modifications were expanding the direct labor base....There is *no evidence that the contracting officers at the time they signed the modifications had any knowledge* of appellant's direct labor base or the extent of any changes therein other than for this particular contract. Moreover, *this reasoning stands the intent of the statutory disclosure requirement on its head*. It allows a contractor

> to escape the consequences of a clear-cut failure to disclose by showing that the contracting officer failed to ferret out the undisclosed costs from bits and pieces of constructive knowledge. (emphasis added) Universal Restoration, Inc., at 78,000.

Administrative Judge Freeman notes that the majority allows the contractor to escape the consequences of a clear-cut failure to disclose by reference to bits and pieces of constructive knowledge (and a Government belief that it had a reasonable price). The Act does not refer to such constructive knowledge, and such a finding limits the Act's requirement for the furnishing of data.

On 2 February 1983, the ASBCA reversed its prior decision in Universal Restoration, by a 3-2 vote (83-1 BCA ¶16,265). The administrative judge who authored the original decision had retired so a new judge was assigned to the panel for the reconsideration. This new judge agreed with the two prior dissenters. The Government is encouraged by the Board's affirmation that there is a legal presumption that the nondisclosure did affect the price, citing American Bosch Arma Corporation, ASBCA No. 10305, 65-2 BCA ¶5280. Particularly satisfying to the Government is the Board's statement that "there is no exception to the Truth in Negotiations Act for fair and reasonable prices."

On the other hand, the Government is concerned that the two dissenters in this reconsideration decision still support the Board's original holding that the contracting officers either knew or should have known that Appellant's overhead rates would be decreasing. The dissenting judges found that the contracting officers chose to rely on prices they found to be fair and reasonable based on independent [Government] pricing, therefore there could be no defective pricing of the contract.

In Central Navigation and Trading Company, ASBCA No. 23946, 82-2 BCA ¶16,074, the Board held that the most accurate, complete and current data were not "reasonably available" to the contractor at the time of negotiation. The Board explained, "Under the unusual circumstances of this case, we are unwilling to assume - as does respondent - that because the data apparently were somewhere in appellant's possession and were relatively uncomplicated - they were reasonably available for preparation of the proposal and the negotiations in Saigon." (The Board found that the contractor was not notified of the need for data until Saturday, 29 June 1974, and certification was required on Sunday in Saigon.)

In Rose, Beaton & Rose, PSBCA No. 459, 80-1 BCA ¶14,242, the Board held that the contractor's overstatement of overhead in its price proposal did not result in any significant increase in the price for the design services rendered. Therefore, the Government was not entitled to a reduction in the contract price (even though the appellant admitted it erroneously included $209,895 in payroll taxes in its overhead). The appellant had argued that the contract price was a compromise figure and was substantially less than its original proposal. (Note: This is what normally takes place in every negotiation.) Thus, the Board, in effect, looked at the resulting negotiated price despite the admitted defective cost or pricing data and, in the process, diluted the natural and probable consequences presumption permitted by DAR 3-807.10(a)(2).

In Lear Siegler, Inc., ASBCA No. 20040, 78-1 BCA ¶13,110, the Board held that the Government was not entitled to a price adjustment for failure of the contractor to disclose a change in its labor hour figure because the Government did not show that this reduced the manufacturing costs and led to an overpricing of the units. The Board also held that the contractor rebutted the Government's allegation by showing the overpricing was too "speculative" despite the admitted failure to disclose.

Decisions such as Whittaker, which require the Government to affirmatively prove that it had no knowledge despite nondisclosure, alter the requirement of the Act to furnish data. [Also, the dissenting judges in Universal Restoration would add constructive knowledge to the list of excuses for nondisclosure. This would change a clear requirement of the Act and allow contractors to escape the Act's consequences for nondisclosure.]

B. Natural and probable consequences of nondisclosure.

The natural and probable consequences doctrine has operated as a presumption allowing downward adjustment in contract price in the amount of defective pricing. Sylvania Electric Products, Inc. v. United States, 479 F.2d 1342 (Ct.Cl. 1973); FMC Corporation, ASBCA No. 10095, 66-1 BCA ¶5483. This presumption, necessary for the effective application of the Truth in Negotiations Act, has its status currently in question because recent decisions have stated that the Government is not entitled to a price reduction where the contractor has a superior bargaining position, or where there has been a "bottom-line" negotiation, because the contractor presumably would not have accepted a lower amount (i.e., where a sole source contractor is involved).

In American Machine & Foundry Company, ASBCA No. 15037, 74-1 BCA ¶10,409, the Board denied the reduction sought under the Truth in Negotiations Act because the Appellant, as a sole source supplier, was in a superior bargaining position at the time of negotiations. The Board decided that the Government failed to prove that any difference in price would have been agreed to had the Government known of a lower vendor's bid. Although the contractor violated the Truth in Negotiations Act, the Board found its failure to disclose may not have caused an increase in price because of its superior bargaining position. This reasoning provides another excuse for nondisclosure. (Particularly disturbing is the fact that a large number of contractors are sole source suppliers or are in a "superior" bargaining position because of other factors such as Government need or urgency for an item.)

In Sperry Univac Division, Sperry Rand Corporation, DOT CAB No. 1144, 82-2 BCA ¶15,812, the Board held that the sole source contractor failed to furnish correct and current cost or pricing data. However, despite finding that the contractor violated the Truth in Negotiations Act by failing to disclose data, the Board held that the Government was not entitled to a reduction in contract price because the Board determined that the contract price was the best the Government could have obtained, even had it known the actual details of the nondisclosed subcontract pricing. Sperry Univac Division, Sperry Rand Corporation, at 78,341. The Government contracting officer and contract negotiator both testified that had they known of the more current, complete and accurate data, the Government would have obtained a lower contract price. However, the Board pointed out that UNIVAC had already reduced its proposal and there was no basis for believing that it would have been willing to accept a futher reduction in its proposed price.

In Conrac Corporation, ASBCA No. 19507, 78-1 BCA ¶12,985, the Board said although the contractor may have failed to disclose information, the Government was not entitled to a price reduction because the parties resorted to a "bottom-line" negotiation and the Board could not conclude that the additional information would have had any effect on the negotiated price.

These cases allow a contractor who has violated the Truth in Negotiations Act to escape the Act's consequences because of the sole source nature of the procurement, the superior bargaining position held by the contractor, or because it was a "bottom-line" negotiation. It represents a complete cycle. The Truth in Negotiations Act was enacted because the contractor all too often knew, or had knowledge of, cost data and estimates not available to the Government. Now, although the Act is violated, the contractor is excused from its nondisclosure because the Board has decided that the superior bargaining position of the contractor or the "bottom-line" settlement means the Government would not have been able to negotiate a lower contract price even if there was full disclosure by the contractor. These cases allow the Board to speculate as to what could have, or would have, occurred in negotiations, and does not comport with either the Act as written or its intent. However, the contracting officer is precluded by regulation from speculating because DAR 3-807.10(a)(2) states that in establishing that defective data caused an increase in the contract price, the contracting officer is not expected to speculate as to what would have been the mental attitudes of the negotiating parties if the correct data had been submitted at the time of agreement on price.

C. Offsets to defective data

There is no indication in the statute that Congress ever intended to allow offsets to defective pricing. Offset means that a contractor's monetary liability for defective data that increases the contract price will be reduced by the amount that other defective data decreased the contract price. Lockheed Aircraft Corp. v. United States, 432 F.2d 801 (Ct.Cl. 1970). The practical effect of an accepted offset is to reduce the contractor's liability for defective data which caused an increase in the contract price. For example, a contractor which has defectively priced the raw material portion of its proposal can claim an offset for purchase orders with subcontractors where the contractor's negotiators were unaware that firm fixed prices higher than they were proposing had already been negotiated with the subcontractor.

In 1967 the Armed Service Board of Contract Appeals decided Cutler-Hammer, Inc., ASBCA No. 10900, 67-2 BCA ¶6432, and strictly interpreted the statute by finding the contractor was not entitled to offsets which would reduce the decrease in contract price obtained by the Government under the defective pricing clause. The

ASBCA read the statute literally and held that it provides a remedy only to the Government. The Board held that offsets would not be permitted unless it could be clearly shown that such treatment was intended by Congress and stated further that a review of the legislative history did not indicate any such clear intent.

However, the Court of Claims reversed the ASBCA and said that the price reduction could be offset by underestimates to the extent of the overestimates. Cutler-Hammer, Inc. v. United States, 416 F.2d 1306 (Ct.Cl. 1969). In Cutler-Hammer, the Court of Claims reviewed the legislative history and stated that, although attempts were made to have offsets cancel out defective pricing, the efforts were to no avail. The Court of Claims, however, utilized the words of Senator Symington, which refuted the testimony of a contractor's vice president who desired offsets. Hearings Before the Senate Committee on Armed Services on H.R. 5532, 87th Congress, 2d Session 100-102 (1962). When the Senator stated: "what we are talking about has to do with negotiations downward, not negotiations upward...", the Court of Claims explained that he may merely have been saying that it was not the intent of Congress to allow understatements greater than overstatements to both cancel out the latter and increase the contract price at the same time. Cutler-Hammer, at 1310.

In an attempt to find both legislative intent and a means to account for a situation where the price of a contract actually should have been higher, the Court of Claims referred to Lord Justice Denning in the English case of Seaford Court Estates Ld. v.

Asher, [1949] 2 K.B. 481 at 498-9, which said that a judge must look not only at the intentions of Parliament through language but also at "social conditions which gave rise to it, and of the mischief which it was passed to remedy..." Id., at 1311. The Court of Claims, thus armed with a rationale for going beyond the words of the statute, then looked at the type of contract involved, and despite agreeing that the contract clause only speaks in terms of "excluding" defective pricing, interpreted the "words [of the statute] to mean that where overstatements exceed understatements, the excess reduces the price; conversely, where understatements exceed overstatements, the price is not raised." Id. at 1312. Such a right has never been statutorily recognized, but through case law has been extended to contract types other than the type used in Cutler-Hammer. The Boards have now followed the Court of Claims' lead in allowing offsets.

IV. Truth in Negotiations Act - View of a Government Trial Attorney

No one can doubt that the Truth in Negotiations Act serves an important function by placing the parties to a negotiation of highly specialized and very expensive defense items on an equal footing. I have heard the Act characterized as "an artificial substitute for competition." Every contractor deserves a fair profit, and extra efficiency deserves a bonus; but negotiated contracts can result in windfalls to a contractor who does not disclose its most accurate, current and complete data. The facts in the cases reviewed clearly indicate that the contractor's failure to disclose is generally caused by the contractor's negligence or indifference.

The intent of Public Law 87-653 is deceptively simple: to require disclosure of cost or pricing data so that the parties are on an equal footing in negotiations. The Act provides a means of reducing the contract price by the amount the defective data inflated the cost, and speaks of recoupment by the Government. The meaning and effect of the Act, strictly construed, and the meaning and intent, as interpreted by case law, differ greatly. The case law has found a rationale for offsets which goes beyond the language and intent of the Act. Once an allegation of defective pricing is made, contractors go to great lengths to find offsets or offer innovative pricing theories as offsets.

The case law also has placed severe and restrictive evidentiary burdens upon Government enforcement of the Act because of the liberal interpretation of the requirement to furnish data to the Government negotiating personnel. The Government must prove the data was not received by anyone in Government employment who might somehow be involved in reviewing the contractor's accounting records. Finally, case law has closed the circle that began with Congress recognizing the superior bargaining position and knowledge of the contractor as a reason for the enactment of Public Law 87-653. Case law strongly implies a nondisclosing contractor may escape the Act's consequences by arguing that because of its superior bargaining position the disclosure of current, accurate and complete data would not have resulted in a lower price to the Government.

The Act can still serve an important role in insuring that the American taxpayer is not paying outrageous profits and excessive prices for necessary defense items. At the present time, the Act, as interpreted by case law, is inhibiting the active and positive assertions of defective pricing in cases that according to the statute do indeed represent defective pricing. Additionally, the Government is concerned that more "excuses" and bad case law will be generated if a case is taken to the Board and lost. The Act is a weapon against excessive costs and profits, but, unfortunately, the case law has blunted this weapon for those charged with enforcement of the Act.

V. Truth in Negotiations Act - Current Problems

A. Appeal of McDonnell Douglas Corporation, ASBCA No. 26747, (Slip Op., 2 Mar 83). In 1978, as part of its continuing oversight of defense acquisitions, GAO selected for study a firm fixed-price 1976 foreign military sales (FMS) contract for the sale of 19 F-4E aircraft to the Republic of Korea. This contract was selected because an initial audit by GAO revealed a profit of 42%, more than twice the 18% profit contemplated in the contract.

Since 1978, GAO has been trying unsuccessfully to get access to certain contractor estimates related to the pricing of this contract. After many requests to the McDonnell Douglas Corporation (MDC), GAO finally issued a subpoena which was delivered to MDC on

2 March 1981, and a second subpoena which was delivered to MDC on 4 January 1982. Both subpoenas were issued pursuant to PL 96-226 (April 3, 1980), 31 U.S.C. §54(c)(1). MDC has refused to comply with either subpoena.

In January 1982, MDC filed an appeal with the ASBCA asking the ASBCA to assume jurisdiction over the action (knowing that a GAO subpoena enforcement action in the Federal District Court in St. Louis, MO was imminent). In January 1982, GAO filed the subpoena enforcement action in the Federal District Court.

The Air Force filed a Motion to Dismiss at the ASBCA, arguing that the Board did not have jurisdiction to determine whether the GAO subpoena should be enforced. The Board had the parties submit briefs and ordered oral argument (upon MDC's Motion) before five ASBCA judges on 20 October 1982.

On 14 December 1982, while the Board had the case under consideration, the Federal District Court, Eastern District of Missouri, held that it has jurisdiction to hear the case because Congress intended the Federal District Courts to handle subpoena enforcement actions.

On 2 March 1983, the ASBCA issued its decision stating that it had jurisdiction over and authority to determine the nature and extent of the contractor's records which the Comptroller General has the right to examine. (However, the Board dismissed the appeal as premature because the Government contracting officer had not issued a final decision.)

MDC has since filed further Motions in the Federal District Court, and has also appealed the ASBCA dismissal to the Court of Appeals for the Federal Circuit. In other words, it will still be a long time, if ever, before any Government employee sees the cost estimates which GAO originally requested back in 1978.

Once the documents are disclosed, the Government will have to decide whether defective pricing (or fraud) existed when MDC priced this 1976 contract. If the Government believes that the contract was defectively priced, then it will probably initiate a claim against MDC. If the Government's claim is sustained by the ASBCA, MDC will probably appeal to the Court of Appeals for the Federal Circuit (CAFC). If the Government is sustained at the CAFC, it should be able to collect its money around 1990.

SUGGESTION: The Government needs a clear statement from Congress that (1) the Truth in Negotiations Act applies to Foreign Military Sales contracts where the United States is involved as an agent for the foreign government, and (2) Congress never intended for GAO subpoena enforcement actions to be decided in the first instance by the ASBCA.

B. I have a docketed appeal before the ASBCA with a contractor which is arguing that the Government auditor saw (in one form or another), or had available to him, cost information during his preaward audit. According to the contractor, this relieved it from disclosing this information to the Government negotiators two months after the pre-award audit. The contractor's argument continues "the Government obviously was aware of the more recent cost or pricing data because it was seen by the auditor in the pre-award audit. Therefore, even though the auditor may not have transmitted his knowledge to the Government negotiators, and even though the data was not given by the contractor to the Government negotiators, disclosure to the auditor during a pre-award audit is enough." Furthermore, the contractor argued, even if the more recent data had been disclosed by the contractor during negotiations, the contractor would not have accepted anything less than it finally negotiated (bottom-line settlement). Finally, the contractor argued that the Government was familiar with the contractor's accounting system and had to have known that more recent work order cost data was available. Therefore, the Government relied upon its independent analysis to justify the agreed-to price, and just negotiated a bottom-line number.

SUGGESTION: The Government needs a clear statement from Congress that availability of data to Government personnel does not relieve (excuse) the contractor from clearly disclosing its most recent, current and accurate data to the Government negotiators, particularly the contracting officer, in a form that would be useful to the Government negotiators.

C. Also, in another current appeal, the Air Force gave a contracting officer's Final Decision to a contractor on 4 May 1982.

On 4 June 1982, the contractor appealed to the ASBCA. On 29 October 1982, the contractor filed a Motion to Deny the Government claim, or, alternatively, to Compel the Government to file the Complaint. On 24 November, the Air Force filed its Opposition to Appellant's Motion. On 30 December 1982, the contractor filed a Reply to the Government's Opposition. The issue involved here, thought by the Government to be elementary, is which party must file the Complaint under the ASBCA rules of procedure.

As of this date, the Board has yet to decide this procedural issue, even though in a similar case another judge in the same ASBCA Trial Division had previously determined that the contractor should file the Complaint (Appeal of McDonnell Douglas Corporation, ASBCA No. 25472, Board's Order of 29 January 1981).

I have been informed that, during this procedural delay, this contractor has hired a full-time employee to "find" offsets.

On the real issue of defective pricing, the contractor claims that there was no reliance by the Government negotiators on the cost or pricing data submitted by the contractor because the Government used its own estimating methodology (involving pre-award audits, and Air Force technical and price analysis) in arriving at a contract price. Finally, the contractor claims that the Defense Contract Audit Agency (DCAA) conducted a pre-award audit and showed no interest in the nondisclosed data. Therefore, it concludes this showed that the Government never intended to rely on the contractor's data. Simply put, the contractor asserts that a critical cost or pricing analysis of the contractor's proposal equates to non-reliance on the proposal by the Government.

SUGGESTION: Congress should make a clear statement that it never intended setoffs to be allowed against the amount of the defective pricing; furthermore, that it never intended to "excuse" nondisclosure of known data, especially updated data, merely because the Government happened to use different analytical and estimating methods of the contractor's proposal. Finally, a DCAA pre-award audit should never "excuse" the contractor from its obligation to disclose any data to the Government negotiators who personally participate in the negotiation process, particularly the contracting officer. Although the auditor may have the data "available" to him in the contractor's records, he may not see it, or he may have another reason for looking at it so that its importance to the negotiations may not be all that obvious to him. Note: An audit is not a 100% verification of the contractor's proposal. There are more contractors doing business with DOD than there are DCAA auditors.

D. In one case currently being litigated, the contractor admits that it proposed a price which included an improper calculation. This contractor has no "excuses" except that it made an honest mistake in calculations (which I assume is a true statement). However, it is claiming offsets against the amount due to the Government which exceed the amount of the Government claim.

Today, this is the rule rather than the exception. That is, the amount of claimed offsets easily exceed the amount of a defective pricing allegation, regardless of the amount of the allegation (i.e., where the Government alleged $19,000,000 in defective pricing, a contractor claimed $42,000,000 in claimed offsets; or, alternatively, the contractor submits hundreds, or even thousands of pages of documentation to support its claimed offsets). Obviously, offsets must be audited to determine their validity, and it can occupy Government personnel for extended periods of time.

Offsets are not really an "excuse" (defense) for nondisclosure, but rather are a remedy in equity. It appears that contractors are attempting to have the Board (and courts) broaden their definition and scope of offsets in order to expand their remedy to Government allegations of defective pricing.

E. In one case, the contractor admits that it did not disclose its profit plan but is arguing that it is not "cost or pricing" data. The contractor has cited E-Systems, Inc., ASBCA No. 17557, 74-2 BCA ¶10,782, which held under the particular facts of that appeal that a contractor's profit plan was not cost or pricing data which needed to be disclosed.

Furthermore, the contractor argues that its standard cost system allows it to "freeze" its costs being proposed to the Government since the Government knows it does not adjust its standards once they are frozen. Therefore, once the contractor discloses its standards (despite more recent data being available), there can be no defective pricing. Although the contractor may update its standard costs for its own purposes, it does not update them for its Government proposals. This contractor fails to recognize the complete difference between an accounting system for accumulating costs and an estimating system for proposing prices.

SUGGESTION: Congress must make it clear that a contractor's accounting system does not excuse it from submitting its most current, accurate, and complete cost or pricing data in its proposals to the Government contracting officer.

F. In a prior case, the Government and prime contractor executed a contract. Subsequently, the prime executed a contract with a subcontractor, and the subcontractor executed a certificate. It was later determined (and admitted) that the subcontractor defectively priced its proposal to the prime.

The subcontractor argued that there was no defective pricing because the Government could not have relied upon the subcontractor's defective data submitted after the Government's "handshake" and execution of the contract with the prime. If the Government and the prime have a firm fixed price contract, there is no harm to the Government in this example. However, if the Government and the prime have an incentive type contract where a share ratio exists, the Government is harmed up to the amount of its share in this example.

SUGGESTION: Congress must close this "loophole" which could allow a subcontractor to defectively price its proposal to a prime anytime after the prime gets a "handshake" on price from the Government.

Questions for Mr. Donald Kinlin

1. The Armed Services Board of Contract Appeals (ASBCA) has altered its position on defective pricing cases over the years. For example, at one time the ASBCA generally took the position that the effect of any defective cost data was a dollar-for-dollar decrease in the contract price. Now, it appears that the cumulative effect of the rulings of the ASBCA is making it virtually impossible for the Department of Defense (DOD) to sustain instances of defective pricing reported by the Defense Contract Audit Agency. ASBCA rulings on burden of proof, absence of contractor's certificate, natural and probable consequences, reliance upon data, setoffs, significance, submission versus availability of data, etc. are all limiting requirements established by the ASBCA which are not to be found in P.L. 87-653. Consequently, it appears that many DOD personnel believe that, regardless of the validity of the DOD position, it is better to settle with the contractor for amounts less than [those to which] they believe DOD is entitled. If they don't, the contractor will appeal to the ASBCA where it is almost certain that the decision will be in favor of the contractor. Please comment on the following matters:

(a) Do you generally concur with the above assessment of the effect of the ASBCA's decisions? If so, please elaborate so that the Committee has a clearer understanding of the impact of the ASBCA's decisions on DOD's ability to implement P.L. 87-653. Discuss various precedents such as those mentioned above which are limiting requirements established by ASBCA. Cite and/or discuss any specific ASBCA decisions which you believe are particularly significant.

Answer. I believe the ASBCA decisions have limited the requirements of P.L. 87-653 by providing many "excuses" not found anywhere in the statute or its legislative history for nondisclosure of data. The ASBCA decisions have been discussed extensively in my previous testimony. In these decisions, the Board is, in effect, forcing the Government to reconstruct the original negotiations in detail to show any harm to the Government, contrary to the natural and probable consequences presumption.

(b) What has your own experience been with (i) contractors and (ii) the ASBCA in arguing the Air Force's position before the ASBCA?

Answer. My experience has been discussed extensively in my prior testimony.

(c) Do you believe the ASBCA decisions have encouraged contractors to appeal contracting officers' decisions which were not favorable to the contractors?

Answer. Yes, I believe that the Board's interpretation of the Truth in Negotiations Act, as it stands today, has encouraged contractors to challenge virtually every finding of defective pricing.

(d) Do you believe the ASBCA decisions have discouraged contracting officers from vigorously pursuing settlements with contractors for full recovery because they feel that the contractors will appeal to the ASBCA where the contracting officers' position will not be sustained?

Answer. I believe that contracting officers are pursuing settlements with contractors for less than the full amount of alleged defective pricing for many reasons. One of the reasons is the growing burden put on the Government by the ASBCA in proving defective pricing. However, I have no doubt that if the Government can carry this burden, the ASBCA will sustain the Government's claim. Other reasons include the amount of effort required by Government personnel who already have full time jobs, and sometimes Government personnel have serious reservations as to the assumptions made by the auditor.

2. Please comment on how you see the overall effectiveness of the DOD's implementation of defective pricing under P.L. 87-653. If you believe that such effectiveness is not adequate, discuss what changes or additions to P.L. 87-653 are needed so that DOD may implement the law in a manner which will achieve the results originally desired by the Congress.

Answer. I believe that DOD's inplementation of P.L. 87-653 has always been effective, but, until approximately 1980, defective pricing was not vigorously pursued within DOD for unknown reasons. However, I can assure you that defective pricing is being vigorously pursued by DOD today. Our only reluctance has been in bringing the cases before the Board.

This is where we need your help. You should have no doubt that if you give us the right weapons, we in the Department of Defense will press for full recovery of all dollars at every level, including the ASBCA.

3. Provide any other comments or suggestions not covered by 1 and 2 above which you believe would be of benefit to the Committee in its deliberations regarding defective pricing.

Answer. I have the following suggestions as to how the Act can be strengthened in order to achieve the results originally intended by Congress:

a. Once certification is required, a non-rebuttable presumption should exist that the contracting officer placed some reliance upon the data submitted by the contractor. Therefore, notwithstanding the fact that the contracting officer fortuitously relied upon some other data as well, the contracator is not excused from its nondisclosure.

b. Making data available, as opposed to active disclosure, in any form whatsoever to DCAA in a pre-award audit should never excuse the contractor from submitting the data, and its effect on the price being negotiated, directly to the contracting officer.

c. Setoffs should not be allowed at all.

d. Subcontractors which defectively price after the Government's "handshake" with the prime contractor should not be allowed to escape the consequences of the Truth in Negotiations Act.

e. Even where the contracting officer should have known (constructive knowledge), the contractor should not be excused for its nondisclosure.

f. Sole source contractors should not be excused for their nondisclosure merely because some believe they would not have accepted a lower price.

g. "Bottom-line" negotiations should not excuse the contractor from disclosing its known data.

h. Contractors should not be immune from the Truth in Negotiations Act when they contract with the United States Government for sales to foreign governments (FMS contracts).

i. GAO subpoena enforcement actions should not be decided by Administrative Boards.

Finally, Congress may want to have defective pricing disputes heard in a forum other than Boards of Contract Appeals. For example, Congress could create an Accounting Court where lawyers who are also accountants would decide, not only defective pricing, but, also Cost Accounting Standards and Cost Principles disputes. See, Accounting Court - An Idea Whose Time Has Come. National Contract Management Journal, Winter 1982.

Thank you for giving me this opportunity to present my views.

DONALD J. KINLIN

PROCUREMENT BY NEGOTIATION

Part 8—Price Negotiation Policies and Techniques

3–800 Scope of Part. This Part sets forth the price negotiation policies and techniques applicable to negotiated prime contracts and those subcontracts which are subject to consent by the Government. The principles in this Part apply to negotiation of prices on all types of contracts and to revised prices as well as initial prices.

3–801 Basic Policy.

3–801.1 *General.* It is the policy of the Department of Defense to procure supplies and services from responsible sources at fair and reasonable prices calculated to result in the lowest ultimate overall cost to the Government. Good pricing depends primarily upon the exercise of sound judgment by all personnel concerned with the procurement.

3–801.2 *Responsibility of Contracting Officers.*

(a) Contracting officers, or their authorized representatives acting within the scope of their authority, are the exclusive agents of their respective Departments to enter into and administer contracts on behalf of the Government in accordance with ASPR and Departmental procedures. Each contracting officer is responsible for performing or having performed all administrative actions necessary for effective contracting. The contracting officer shall avail himself of all appropriate organizational tools such as the advice of specialists in the fields of contracting, finance, law, contract audit, packaging, engineering, traffic management, and price analysis.

(b) To the extent services of specialists are utilized in the negotiation of contracts, the contracting officer must coordinate a team of experts, requesting advice from them, evaluating their counsel, and availing himself of their skills. He shall not, however, transfer his own responsibilities to them. Thus, determination of the suitability of the contract price to the Government always remains the responsibility of the contracting officer. For certain acquisitions, it may be necessary to convene a formal "Should Cost" (see 1–337) team of specialists to evaluate the contractor's cost projections, supporting standards, and other in-plant management, operational, and performance practices, on which cost projections are based.

(c) When the contractor insists on a price or demands a profit or fee which the contracting officer considers unreasonable, the contracting officer shall (i) determine the feasibility of developing an alternate source of supply, or (ii) take any other action within his authority. If, after exhausting the above course of action, a satisfactory solution has not been obtained, the contracting officer shall refer the prospective procurement to higher authority. Such referral shall include a complete statement of the attempt made to resolve the matter. With regard to a contractor's refusal to provide cost or pricing data, see 3–807.5.

(d) Pricing based on cost analysis involves, among other things, an appraisal of estimates of costs expected to be incurred in the future. The accounting projection of trends based on cost or pricing data, together with any known changes therein, is only one method of conducting this appraisal, others being:

(i) an engineering appraisal of the need for the estimated labor and material costs and of tooling and facilities, and the reasonableness of scrap and spoilage factors, and

(ii) the preparation of independent estimates by competent technical personnel.

Occasionally, differences of opinion will exist not only on the reasonableness of cost projections but also on the accounting techniques on which they are based. In addition, it is normally not possible to negotiate a pricing result which is in strict accord with all of the opinions of all of the specialists, or even with the Government's pricing objective. Reasonable compromises are normally necessary and this fact must be understood by all members of the team. For all of these reasons audit reports or pricing recommendations by others must be considered to be advisory only. The contracting officer is responsible for the exercise of the requisite judgments and is solely responsible for the final pricing decision. When the contracting officer does not adopt audit or other specialist recommendations that have particular significance on the contract price, comments should be included in the record of the negotiation.

(e) Whenever it becomes apparent to the contracting officer that the negotiations will require the resolution of complex problems which involve items significant in amount, he shall request attendance by audit or other representatives at the negotiation meeting.

(f) Contracting offices shall cover the disposition of each audit report as follows:

(i) For the audit report where the procurement action was finalized, the cognizant auditor shall be notified in accordance with the requirement of 3-811.

(ii) For those situations where the audit report is related to a cancelled or unsuccessful procurement action, the cognizant auditor shall be notified in writing.

3-801.3 *Responsibility of Requirements and Other Logistics Personnel in Purchasing Offices.* Personnel other than the contracting officer, who determine type, quality, quantity, and delivery requirements for items to be purchased, can influence the degree of competition obtainable and exert a material effect upon prices. Failure to determine requirements in sufficient time to allow:

(i) a reasonable period for preparation of requests for proposals;

(ii) preparation of quotations by offerors;

(iii) contract negotiation and preparation; or

(iv) adequate manufacturing lead time,

causes delays in deliveries and uneconomical prices. Requirements issued on an urgent basis or with unrealistic delivery schedules should be avoided since they generally increase prices or restrict desired competition.

3-801.4 *Responsibility of Pricing Personnel in Purchasing Office.*

(a) The contract pricing team available to support the PCO in the review and analysis of pricing proposals includes the price analyst, negotiator, buyer, project engineer, and liaison auditor at the purchasing office.

(b) The price analyst or negotiator supporting the contracting officer may be designated to develop a Government pricing objective prior to the negotiation. This includes the responsibility for determining the extent of advice required from other specialists, requesting, obtaining, and considering such advice, and for consolidating pricing data, including cost and price analyses, historical cost or pricing data, independent government cost estimates, economic analyses and the like. The advice and assistance of the price analyst/negotiator should always be obtained when complex pricing techniques are indicated, including the use of con-

(i) actual costs previously incurred by the contractor or offeror;
(ii) either his last prior cost estimate or a series of prior estimates for the same or similar items;
(iii) current cost estimates from other possible sources;
(iv) prior estimates or historical costs of other contractors manufacturing the same or similar items; and
(v) forecasts or planned expenditures.

(4) Forecasting future trends in costs from historical cost experience is of importance, but care must be taken to assure that the effect of past inefficient or uneconomical practices are not projected into the future. An adequate cost analysis must include an evaluation of trends and changes in circumstances, if any, and their effect on future costs.

3–807.3 *Requirement for Cost or Pricing Data.*

(a) When appropriate, the contracting officer shall require the contractor to submit, either actually or by specific identification in writing, cost or pricing data in support of his proposal. The contracting officer also shall require the contractor, in circumstances specified in (b) below, to certify, using the certificate set forth in 3–807.6, that the cost or pricing data submitted are accurate, complete, and current. Cost or pricing data shall not be required merely in anticipation of post-award review of the contract.

(b) Cost or pricing data are required as part of a proposal leading to, and certification is required prior to:

(i) the award of any negotiated contract (except for unpriced actions such as letter contracts) expected to exceed $500,000 in amount;
(ii) the pricing of any modification to any formally advertised or negotiated contract whether or not cost or pricing data were required in connection with the initial pricing of the contract when the modification involves aggregate increases and/or decreases in costs plus applicable profits expected to exceed $500,000. (For example, the requirement applies to a $150,000 modification resulting from a reduction of $350,000 and an increase of $200,000, or as another example, when the modification results in no change in contract price because there is an increase of $1 million and a reduction of $1 million. However, this requirement shall not apply when unrelated and separately priced changes for which cost or pricing data would not be required are included in the same modification for administrative convenience.);
(iii) the award of any negotiated contract not expected to exceed $500,000 in amount, or any contract modification not expected to exceed $500,000 in amount to any contract whether or not cost or pricing data were required in connection with the initial pricing of the contract, provided the contracting officer considers that the circumstances warrant such action;

unless the price negotiated is based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation. The requirements under (i) and (ii) above may be waived in exceptional cases when the Secretary (or, in the case of a contract with a foreign government or agency thereof, the Head of a Contracting Activity) authorizes such waiver and states in writing his reasons for such determination. A copy of each waiver shall be sent to the Assistant Deputy Under Secretary of Defense for Acquisition (ADUSD(A)), OUSD(R&E).

(c) Unless required to be submitted on one of the termination forms set forth in 16-700, data will be submitted on the DD Form 633. The requirement for submission of cost or pricing data is met when all cost or pricing data reasonably available to the contractor have been submitted or identified in writing at the time of agreement on price. The data shall be submitted to the contracting officer or his representative. There is a clear distinction to be made between "submitting" cost or pricing data and merely "making available" books, records and other documents without identification. The latter does not constitute submission of cost or pricing data.

(d) Certified cost or pricing data shall not be requested prior to the award of any contract anticipated to be for $25,000 or less (but see 22-1007) and generally should not be requested for modifications in those amounts. There should be relatively few instances where certified cost or pricing data and the inclusion of defective pricing clauses would be justified in awards between $25,000 and $500,000. In most such awards, the administrative costs will outweigh the benefits which might otherwise accrue from receipt of certified cost or pricing data; hence all other means of determining reasonableness of price should be utilized. When less than complete cost analysis (*e.g.*, analysis of only specific factors) will provide a reasonable pricing result on awards under $500,000 without the submission of complete cost or pricing data, the contracting officer shall request only that data which he considers adequate to support the limited extent of the cost analysis required and he will not require certification.

(e) When it is anticipated from the outset that there will be adequate price competition, cost or pricing data shall not be requested regardless of the dollar amount involved. If, after cost or pricing data were initially requested and received, it is determined that adequate price competition does exist, the data need not be certified. As a general rule, cost or pricing data should not be requested when it has been determined that proposed prices are, or are based on, established catalog or market prices of commercial items sold in substantial quantities to the general public or are prices set by law or regulation. When, however, despite the existence of an established catalog or market price of commercial items sold in substantial quantities to the general public, the contracting officer finds that the price is not reasonable and supports such finding by an enumeration of the facts upon which it is based, cost or pricing data may be requested if necessary to establish a reasonable price; *provided*, that such finding is approved by the Chief of the Purchasing Office.

(f) When economic price adjustment provisions are included in competitive procurements, see 3-404.3(e).

ADDENDUM

PROCUREMENT BY NEGOTIATION

3-807.4 *Subcontractor Cost or Pricing Data.*

(a) Any contractor who is required to submit and certify cost or pricing data shall be required to submit accurate, complete and current cost or pricing data from prospective subcontractors in support of each subcontract cost estimate included in the contractor's submission. This submission shall be required whenever the contracting officer considers such subcontractor data necessary for pricing the prime contract, or, in any event, whenever such subcontractor cost estimate is either (i) $1,000,000 or more, or (ii) both more than $500,000 and more than 10 percent of the prime contractor's proposed contract price. This submission is not required if the contractor demonstrates to the satisfaction of the contracting officer that a prospective subcontract will be based on adequate price competition, or that a prospective subcontract estimate is based on an established catalog or market price of a commercial item sold in substantial quantities to the general public, or a price set by law or regulation. Except for subcontracts within (i) or (ii) above, any such requirement for subcontractor cost or pricing data may be limited by the contracting officer to particular subcontract items or classes of items. However, in the case of subcontracts of $500,000 or less, any such requirement shall be subject to the limitations for contracts of $500,000 or less as set forth in 3-807.3(d). Submission of subcontractor cost or pricing data from more than one subcontractor for each subcontract item shall not ordinarily be required, provided that the contractor's subcontract cost estimate is based upon the cost or pricing data of the subcontractor who is most likely to get the subcontract. Notwithstanding the foregoing, the contractor shall submit other data pertaining to subcontract costs, including other subcontractor quotations.

(b) Prospective subcontractor cost or pricing data shall be accurate, complete and current as of the same date specified in the contractor's certificate. The contractor shall be responsible for updating a prospective subcontractor's data to the above date from the time of original submission by the subcontractor. Failure by the contractor to submit subcontract cost or pricing data may be cause for disqualification of the contractor from further consideration for award of the proposed contract. When the contractor has generally complied with such subcontract cost or pricing data requirements, his failure to do so for particular subcontracts in exceptional cases may be excused by the contracting officer. Such excuse, except when limited to an allowance of additional time, shall be approved by the Chief of the Purchasing Office. For each prospective subcontract so excused, the contracting officer shall either (i) allow additional time for submission of subcontract cost or pricing data up to the date of agreement upon the prime contract price; (ii) withdraw the requirement for subcontract cost or pricing data if he deems that cost or pricing data submitted by the contractor is adequate to support the subcontract estimate; (iii) reserve such subcontract item for future pricing; (iv) consider another contract type; or (v) make other arrangements to provide an adequate basis for agreement upon contract price. Also, for each subcontract so excused, the contractor shall remain obligated to obtain subcontractor cost or pricing data.

(c) These requirements, modified as appropriate to relate to a higher tier subcontractor rather than the prime contractor, shall apply to lower tier subcontracts under subcontracts for which subcontractor cost or pricing data are required.

(d) The contractor shall be required to support subcontract cost estimates below the minimum set forth in (a)(i) and (ii) above, by any data or information needed to establish a reasonable contract price.

(e) Any contractor who has been required to submit and certify cost or pricing data also shall be required to obtain cost or pricing data from his subcontractors under the circumstances set forth in the appropriate clause in 7-104.42, notwithstanding any prior submission from subcontractors. The requirements for submission of subcontractor cost or pricing data for subcontracts may be waived in exceptional cases when the Secretary (or his designee in cases when the subcontract is with a foreign government or agency thereof or is for less than $1 million) authorizes such waiver and states in writing his reasons for such determinations. A copy of each waiver shall be sent to the Assistant Deputy Under Secretary of Defense for Acquisition, Office of the Under Secretary of Defense, Research and Engineering.

(f) Cost or pricing data furnished by a subcontractor or a prospective subcontractor must be submitted to the prime contractor or higher-tier subcontractor. It is the responsibility of the prime contractor and higher-tier subcontractor to review and evaluate the subcontract proposal and supporting cost or pricing data and furnish the results of such review and evaluation to the Government as part of their cost or pricing data submission.

3–807.5 *Refusal to Provide Cost or Pricing Data.* If cost or pricing data from the contractor are required to permit adequate analysis of the contractor's proposal and the contractor has refused to provide such data, the contracting officer shall use those means available to him in attempting to secure such data. If the contractor persists in his refusal to provide necessary data, the contracting officer shall withhold making the award or price adjustment. In such event, he shall refer the procurement action to higher echelons of the Department. Such referral shall include a complete statement of the attempts made to resolve the matter, including (i) steps taken to secure essential cost or pricing data, (ii) efforts to secure the contractor's cooperation in the establishment of a satisfactory business relationship, (iii) any assurances offered, such as agreements to adequately safeguard information furnished, and (iv) a statement concerning the practicability of obtaining the supplies or services from another source.

3–807.6 *Certificate of Current Cost or Pricing Data.*

(a) When a Certificate of Current Cost or Pricing Data is required, the certificate set forth below shall be included in the contract file along with the memorandum of the negotiation, see 3–811. The contractor shall be required to submit only one certificate which shall be submitted as soon as practicable after agreement is reached on the contract or modification price.

CERTIFICATE OF CURRENT COST OR PRICING DATA

This is to certify that, to the best of my knowledge and belief, cost or pricing data as defined in ASPR 3–807.1(a)(1) submitted, either actually or by specific identification in writing (see ASPR 3–807.3(a)) to the Contracting Officer or his representative in support of . . . .* are accurate, complete, and current as of (day) (month) (year) . . . .**

This certification includes the cost or pricing data supporting any advance agreement(s) and forward pricing rate agreements between

ADDENDUM

7-104.28 *Quality Program*. In accordance with 14-304, insert the following clause.

QUALITY PROGRAM (1967 AUG)

The Contractor shall provide and maintain a quality program acceptable to the Government for supplies and services covered by this contract. The quality program shall be in accordance with the edition of Military Specification MIL-Q-9858 in effect on the date of this contract.

(End of clause)

7-104.29 *Price Reduction for Defective Cost or Pricing Data*.

(a) The following clause shall be inserted in negotiated contracts which when entered into exceed $500,000, except where the price is based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation. In addition the contracting officer shall include this clause in other negotiated contracts for which he has obtained a Certificate of Current Cost or Pricing Data in accordance with 3-807.3(b)(iii) in connection with the initial pricing of the contract, or for which he has obtained partial cost or pricing data in accordance with 3-807.3(d).

PRICE REDUCTION FOR DEFECTIVE COST OR PRICING DATA (1970 JAN)

If any price, including profit or fee, negotiated in connection with this contract or any cost reimbursable under this contract was increased by any significant sums because:

(i) the Contractor furnished cost or pricing data which was not complete, accurate and current as certified in the Contractor's Certificate of Current Cost or Pricing Data;

(ii) a subcontractor, pursuant to the clause of this contract entitled "Subcontractor Cost or Pricing Data" or "Subcontractor Cost or Pricing Data—Price Adjustments" or any subcontract clause therein required, furnished cost or pricing data which was not complete, accurate and current as certified in the subcontractor's Certificate of Current Cost or Pricing Data;

(iii) a subcontractor or prospective subcontractor furnished cost or pricing data which was required to be complete, accurate and current and to be submitted to support a subcontract cost estimate furnished by the Contractor but which was not complete, accurate and current as of the date certified in the Contractor's Certificate of Current Cost or Pricing Data; or

(iv) the Contractor or a subcontractor or prospective subcontractor furnished any data, not within (i), (ii) or (iii) above, which was not accurate as submitted;

the price or cost shall be reduced accordingly and the contract shall be modified in writing as may be necessary to reflect such reduction. However, any reduction in the contract price due to defective subcontract data of a prospective subcontractor when the subcontract was not subsequently awarded to such subcontractor, will be limited to the amount (plus applicable overhead and profit markup) by which the actual subcontract, or actual cost to the Contractor if there was no subcontract, was less than the prospective subcontract cost estimate submitted by the Contractor, *provided* the actual subcontract price was not affected by defective cost or pricing data.

Note: Since the contract is subject to reduction under this clause by reason of defective cost or pricing data submitted in connection with certain subcontracts, it is expected that the contractor may wish to include a clause in each such subcontract requiring the subcontractor to appropriately indemnify the contractor. However, the inclusion of such a clause and the terms thereof are matters for negotiation and agreement between the contractor and the subcontractor, *provided* that they are consistent with ASPR 23-203 relating to Disputes provisions in subcontracts. It is also expected that any subcontractor subject to such indemnification will generally require substantially similar indemnification for defective cost or pricing data required to be submitted by his lower tier subcontractors.

(End of clause)

ADDENDUM

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DAC #76-41 27 DECEMBER 1982

CONTRACT CLAUSES AND SOLICITATION PROVISIONS

(b) Insert the following clause in all contracts, both formally advertised and negotiated, which when entered into exceed $500,000 except those containing the clause in (a) above.

PRICE REDUCTION FOR DEFECTIVE COST OR PRICING DATA—PRICE ADJUSTMENTS (1982 DEC)

(a) This clause shall become operative only with respect to any modification of this contract which involves aggregate increases and/or decreases in costs plus applicable profits in excess of $500,000 unless the modification is priced on the basis of adequate competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation. The right to price reduction under this clause is limited to defects in data relating to such modification.

(b) If any price, including profit, or fee, negotiated in connection with any price adjustment under this contract was increased by any significant sums because:

(i) the Contractor furnished cost or pricing data which was not complete, accurate and current as certified in the Contractor's Certificate of Current Cost or Pricing Data;

(ii) a subcontractor, pursuant to the clause of this contract entitled "Subcontractor Cost or Pricing Data" or "Subcontractor Cost or Pricing Data—Price Adjustments" or any subcontract clause therein required, furnished cost or pricing data which was not complete, accurate and current as certified in the subcontractor's Certificate of Current Cost or Pricing Data;

(iii) a subcontractor or prospective subcontractor furnished cost or pricing data which was required to be complete, accurate and current and to be submitted to support a subcontract cost estimate furnished by the Contractor but which was not complete, accurate and current as of the date certified in the Contractor's Certificate of Current Cost or Pricing Data; or

(iv) the Contractor or a subcontractor or prospective subcontractor furnished any data, not within (i), (ii) or (iii) above, which was not accurate, as submitted;

the price shall be reduced accordingly and the contract shall be modified in writing as may be necessary to reflect such reduction. However, any reduction in the contract price due to defective subcontract data of a prospective subcontractor, when the subcontract was not subsequently awarded to such subcontractor, will be limited to the amount (plus applicable overhead and profit markup) by which the actual subcontract, or actual cost to the Contractor if there was no subcontract, was less than the prospective subcontract cost estimate submitted by the Contractor, *provided* the actual subcontract price was not affected by defective cost or pricing data.

Note: Since the contract is subject to reduction under this clause by reason of defective cost or pricing data submitted in connection with certain subcontracts, it is expected that the contractor may wish to include a clause in each such subcontract requiring the subcontractor to appropriately indemnify the contractor. However, the inclusion of such a clause and the terms thereof are matters for negotiation and agreement between the contractor and the subcontractor, *provided* that they are consistent with ASPR 23-203 relating to Disputes provisions in subcontracts. It is also expected that any subcontractor subject to such indemnification will generally require substantially similar indemnification for defective cost or pricing data required to be submitted by his lower tier subcontractors.

(End of clause)

(c) The requirement for inclusion of the above clauses in contracts with foreign governments or agencies thereof may be waived in exceptional cases by the Head of a Procuring Activity, stating in writing his reasons for such determination.

sistent with this contract, including demand consequent upon default termination; (iii) the date of transmittal by the Government to the Contractor of a proposed supplemental agreement to confirm completed negotiations fixing the amount; or (iv) if this contract provides for revision of prices, the date of written notice to the Contractor stating the amount of refund payable in connection with a pricing proposal or in connection with a negotiated pricing agreement not confirmed by contract supplement.

(End of clause)

The interest rates established by the Secretary of the Treasury will be published in the Federal Register every six months. The current rate may also be obtained from the Departmental Contract Finance Office representative.

7-104.40 *Competition in Subcontracting.* The following clause shall be included in all negotiated contracts over $10,000, except in firm fixed-price contracts where award is on the basis of effective price competition or where prices are established by law or regulation, and except in small purchases made pursuant to 3-600.

COMPETITION IN SUBCONTRACTING (1962 APR)

The Contractor shall select subcontractors (including suppliers) on a competitive basis to the maximum practical extent consistent with the objectives and requirements of the contract.

(End of clause)

7-104.41 *Audit by Department of Defense.*

(a) Insert the following clause in all contracts (except those entered into by formal advertising which are not expected to exceed $100,000, and except small purchases made pursuant to 3-600).

AUDIT BY DEPARTMENT OF DEFENSE (1982 DEC)

(a) *General.* The Contracting Officer or his representatives shall have the audit and inspection rights described in the applicable paragraphs (b), (c) and (d) below.

(b) *Examination of Costs.* If this is a cost reimbursement type, incentive, time and materials, labor hour, or price redeterminable contract, or any combination thereof, the Contractor shall maintain, and the Contracting Officer or his representatives shall have the right to examine books, records, documents, and other evidence and accounting procedures and practices, sufficient to reflect properly all direct and indirect costs of whatever nature claimed to have been incurred and anticipated to be incurred for the performance of this contract. Such right of examination shall include inspection at all reasonable times of the Contractor's plants, or such parts thereof, as may be engaged in the performance of this contract.

(c) *Cost or Pricing Data.* If the Contractor submitted cost or pricing data in connection with the pricing of this contract or any change or modification thereto, unless such pricing was based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation, the Contracting Officer or his representatives who are employees of the United States Government shall have the right to examine all books, records, documents and other data of the Contractor related to the negotiation, pricing or performance of such contract, change or modification, for the purpose of evaluating the accuracy, completeness and currency of the cost or pricing data submitted. Additionally, in the case of pricing any change or modification to formally advertised contracts, the Comptroller General of the United States or his representatives who are employees of the United States Government shall have such rights. The right of examination shall extend to all documents necessary to permit adequate evaluation of the cost or pricing data submitted, along with the computations and projections used therein.

(d) *Reports.* If the Contractor is required to furnish Contractor Cost Data Reports (CCDR), Contract Fund Status Reports (CFSR), or Cost Performance Reports (CPR) the Contracting Officer or his representatives shall have the right to examine books, records, other documents, and supporting materials, for the purpose of evaluating (i) the effectiveness of the Contractor's policies and procedures to produce data compatible with the objectives of these reports, and (ii) the data reported.

(e) *Availability*. The materials described in (b), (c) and (d) above shall be made available at the office of the Contractor, at all reasonable times, for inspection, audit, or reproduction, until the expiration of three (3) years from the date of final payment under this contract or such lesser time specified in Appendix M of the Armed Services Procurement Regulation, and for such longer period, if any, as is required by applicable statute, or by other clauses of this contract, or by (1) and (2) below:

(1) If this contract is completely or partially terminated, the records relating to the work terminated shall be made available for a period of three (3) years from the date of any resulting final settlement.

(2) Records which relate to appeals under the "*Disputes*" clause of this contract, or litigation, or the settlement of claims arising out of the performance of this contract, shall be made available until such appeals, litigation, or claims have been disposed of.

(f) The Contractor shall insert a clause containing all the provisions of this clause, including this paragraph (f), in all subcontracts exceeding $10,000 hereunder, except altered as necessary for proper identification of the contracting parties and the Contracting Officer under the Government prime contract.

(End of clause)

(b) In the case of consolidated facilities contracts, facilities acquisition contracts and facilities use contracts, paragraph (b) of the clause should be amended to read:

(b) *Examination of Costs*. The Contractor shall maintain, and the Contracting Officer and his representatives shall have the right to examine, books, records, documents, and other evidence and accounting procedures and practices, sufficient to reflect properly (1) all direct and indirect costs of whatever nature claimed to have been incurred and anticipated to be incurred for the performance of this contract and (2) the use of, and charges for the use of, the facilities. Such right of examination shall include inspection at all reasonable times of the Contractor's plants, or such parts thereof, as may be engaged in the performance of this contract.

7–104.42 *Subcontractor Cost or Pricing Data.*

(a) The following clause shall be inserted in all negotiated contracts expected to exceed $500,000, except where the price is based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation. The contracting officer may include this clause, with appropriate reduction in the dollar amounts included therein, in other negotiated contracts where a Certificate of Current Cost or Pricing Data is required (see 3–807.3(b)(iii)) in connection with initial pricing of the contract.

SUBCONTRACTOR COST OR PRICING DATA (1982 DEC)

(a) The Contractor shall require subcontractors hereunder to submit, actually or by specific identification in writing, cost or pricing data under the following circumstances: (i) prior to the award of any subcontract the amount of which is expected to exceed $500,000 when entered into; (ii) prior to the pricing of any subcontract modification which involves aggregate increases and/or decreases in costs plus applicable profits expected to exceed $500,000; except where the price is based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation.

(b) The Contractor shall require subcontractors to certify, in substantially the same form as that used in the certificate by the Prime Contractor to the Government, that to the best of their

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Accounting Court—An Idea Whose Time Has Come

by Donald J. Kinlin*

INTRODUCTION

In the May and June 1979 issues of the *Government Executive*, Mr. Frederick Neuman, Director, Defense Contract Audit Agency, proposed an Accounting Court to decide the purely accounting issues raised by Cost Accounting Standards (CAS).[1] Mr. Neuman believes that an important advantage of this accounting court would be the opportunity for its members to specialize and gain expertise in accounting principles and Cost Accounting Standards (CAS). He concludes that this specialization would allow the accounting court to expedite its decision once a case has been heard. This article will show that Mr. Neuman's proposal for an accounting court is an idea whose time has come, and that an accounting court composed of attorneys with accounting expertise would allow for a more expeditious handling of purely accounting issues than is available under the present disputes procedure.

COST ACCOUNTING STANDARDS (CAS)

On July 1, 1968, Public Law 90-370, 82 Stat. 279, required the Comptroller General of the United States to determine "the feasibility of applying uniform cost accounting standards to be used in all negotiated prime contract and subcontract defense procurements of $100,000 or more." On January 19, 1970, GAO issued Report B-39995(1) which concluded that it was "feasible to establish and apply cost accounting standards to provide a greater degree of uniformity and consistency in cost accounting as a basis for negotiating and administering procurement contracts." Following receipt of the feasibility study, Congress enacted Public Law 91-379, 84 Stat. 796, on August 15, 1970. This legislation, which became Section 719 of the Defense Production Act of 1950, established the Cost Accounting Standards Board. Section 719(g) provides "the Board shall from time to time promulgate cost accounting standards designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors and subcontractors under Federal Contracts."

COST ACCOUNTING STANDARDS BOARD

The Cost Accounting Standards Board was established in 1970. The first Cost Accounting Standards (CAS 400, 401, and 402) were effective on 1 July, 1972. In September 1979, the Cost Accounting Standards Board published Cost Accounting Standard 420, effective March 15, 1980, and in May 1980, Cost Accounting Standard 418, Allocation of Direct and Indirect Costs, was published, effective September 20, 1980. On 30 September 1980, the CAS Board officially ceased to exist because Congress failed to appropriate any funds to continue the CAS Board for FY 81. In the meantime, Congress also failed to transfer the Board's authority and function to any other agency. Therefore, it appears that the courts and contract appeals boards will be kept busy the next few years clarifying, interpreting or modifying the CAS Board's rules, regulations and standards.

The CAS Board was the authoritative body for cost accounting principles to be used in pricing and costing Government contracts. That is, Cost Accounting Standards take precedence over generally accepted accounting principles (GAAP) if there is any conflict. Conflict between them does occur because the CAS Board has set up slightly different terminology, and has narrowed the choice of alternatives available to contractors for the pricing and costing of Government contracts under generally accepted accounting principles.

CAS is a relatively new and still developing body of cost principles. As a result, there have been disputes between the Government and contractors as to the interpretation of Cost Accounting Standards, and there is an established procedure for the resolution of these CAS disputes.

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DISPUTE PROCEDURE

Section 719(h)(1), Public Law 91-379, provides that:

> If the parties fail to agree as to whether the defense contractor or subcontractor has complied with cost-accounting standards, the rules and regulations relating thereto, and cost adjustments demanded by the United States, such disagreement will constitute a dispute under the contract dispute clause.

Therefore, paragraph 6 of the CAS clause, which is included in all negotiated defense contracts which exceed $100,000 (with a few exceptions), provides that failure to agree over certain matters shall constitute a dispute concerning questions of fact and be subject to the disputes clause of the contract. The disputes clause under the Contract Disputes Act of 1978 (P.L. 95-563, 41 U.S.C.§ 601, *et seq.*) allows a Department of Defense (DOD) contractor to file a CAS related dispute with the Armed Services Board of Contract Appeals (ASBCA) within 90 days, or directly with the Court of Claims within one year from the date of receipt of a contracting officer's final decision. If the contractor selects the ASBCA, then either party has the right of appeal to the Court of Claims within 120 days of receipt of the ASBCA decision.

DAR COST PRINCIPLES

In addition to being subject to Cost Accounting Standards, contractors that deal with the Government are also subject to the Government's procurement regulations. The Department of Defense has developed its own code of procurement and cost determination regulations. The Defense Acquisition Regulation (DAR) is issued by the Department of Defense and contains DOD's rules, regulations, policies and procedures governing the procurement of supplies and services. The DAR is updated periodically by the DAR Council.[2] The DAR has twenty-six sections and several appendices. Section XV contains the Cost Principles which, along with CAS, are used to determine cost allocability and allowability for defense contracts. The current DAR Section XV Cost Principles were preceded by the original edition of the Armed Services Procurement Regulation (ASPR), dated 19 May 1948, and its predecessors the Green Book[3] and T.D. 5000.[4]

The original ASPR Cost Principles underwent a strong and heated debate in the procurement and legal communities during most of the 1950's. The ASPR Committee, after more than five years of study, examination and debate, and with the benefit of comments from industry, issued the ASPR Section XV Cost Principles, thereby making some items previously allowable, unallowable. This ASPR, referred to as the November 30, 1959 version, clearly changed numerous provisions. It also created a new set of comprehensive, uniform "cost principles" to be used for the determination of allowable costs on DOD contracts. The following factors were used to determine whether a particular cost should be allowed:

—Reasonableness
—Allocability
—Limitations or exclusions in Contracts or Regulations
—Generally Accepted Accounting Principles (GAAP)

The limitations or exclusions in the regulations refers to the "selected costs" provision which discusses in detail approximately fifty cost elements or types of expenses, and it provides guidance on their allowability. Once the CAS Board came into being, the ASPR added another factor:

—CAS if applicable, otherwise
—GAAP

Early in 1978, the ASPR's name was changed to DAR.[5]

The disputes clause under the Contract Disputes Act of 1978 also allows a DOD contractor to file a DAR Section XV Cost Principle dispute with the ASBCA within 90 days, or directly with the Court of Claims within one year from the date of receipt of a contracting officer's final decision.

DISPUTES

The ASBCA has already determined that the rule of legislative interpretation, not contract construction, is applicable to CAS disputes. *Appeal of The Boeing Company*, ASBCA No. 19224, 77-1 BCA¶ 12,371, *affirmed on reconsideration* (1979).[6] Therefore, the ASBCA will look to the intent of the CAS Board as expressed in a Standard. If the intent of the CAS Board is not plain, the ASBCA will examine the conditions, opinion, public comments, and background which preceded a Standard's promulgation. The same standard of review applies to DAR Section XV Cost Principles disputes. A court or board has the duty to look to the intent of the DAR Council (ASPR Committee) as expressed in the regulation. *Philbrook v. Glodgett*, 421 U.S. 707 (1975); *Sinclair Refining Co. v. Atkinson*, 370 U.S. 195 (1962). Legislative history is unnecessary when the language and purpose of the regulation is plain. *United States v. Missouri-Pacific R.R.*, 278 U.S. 269, 277-78 (1929). Furthermore, in construing administrative regulations, the ultimate criterion is the administrative interpretation, which becomes of controlling weight, unless it is plainly erroneous or inconsistent with the regulation. *United States v. Larionoff*, 431 U.S. 864, 872 (1977); *Barrington Manor Apts. Corp. v. United States*, 198 Ct.Cl. 298, 304, 459, F.2d. 499, 502-03 (1972). However, if the intent of the regulation is not clear, the court or board will review the history of the regulation.

See, e.g., Blue Cross Association v. United States, 200 Ct.Cl. 716, 474 F.2d 754 (1973); *LTV Aerospace Corp. and Advanced Technology Center, Inc.*, ASBCA No. 17130, 76-1 BCA ¶ 11,840. Also, the *contra proferentem* rule does not apply to regulations.[7] The fact that a regulation may be incorporated into a contract does not require a different rule for regulation interpretation. *Honeywell Inc. v. The United States*, ___ F.2d ___, No. 443-79 C, Slip Op. (Ct.Cl., Sep 23, 1981).

CAS and DAR Section XV disputes are unique because they usually deal with purely accounting issues. However, the judges who decide these cases generally have a limited accounting background. Because of this limited expertise, the attorneys must spend a lot of time presenting basic accounting concepts. Each side feels compelled to hire expert accounting witnesses to explain simple accounting terms and principles. Consequently, the trials are quite lengthy. In one CAS case that took three weeks to try, the Appellant used four "outside" experts, two corporate accountants, and one corporate statistician. The Government used one "outside" expert, two Government accountants, and one Government statistician.[8] The use of many experts to explain accounting concepts and practices is very expensive and time consuming for both sides. Additionally, once the case is tried, attorneys from both sides must argue accounting concepts and principles in their post-trial briefs.

The objective of the present disputes procedure is to provide a quick administrative remedy for contractors. However, under this procedure, a decision on an accounting issue may take anywhere from six months to several years from the date of the trial. One CAS dispute involving the disallowance of January and February 1974 costs, was tried before the ASBCA in May 1975, decided in February 1977, and affirmed by the Board on the contractor's motion for reconsideration in January, 1979. It is presently on appeal at the Court of Claims.[9]

ACCOUNTING COURT

In the May and June 1979 issues of the *Government Executive*, Mr. Frederick Neuman's article, "Auditing Rationale at Defense," proposed an Accounting Court. Although the concept of an accounting court is not new, Mr. Neuman's Court for Cost Accounting Standards (CAS) would serve a different function than that envisioned by Leonard Spacek.[10] CAS disputes normally involve cost allocation questions, while the DAR Section XV Cost Principles disputes normally involve cost allowability questions. CAS and DAR Section XV Cost Principles disputes usually require lengthy trials that go into great detail on complex accounting matters. These trials are heard and decided by judges who are not accountants, but who must interpret the meaning of applicable Cost Accounting Standards and DAR Section XV Cost Principles.

Mr. Neuman's proposal for an accounting court raises many questions. For example, if we have an accounting court, why not an engineering, medical, construction or other specialized court? Would the individual(s) designated to hear the specialized disputes be familiar with the question, and, therefore, have already formed an opinion? Would these specialists be full-time members of the court, would they sit for a specified time, or would they be selected on a case-by-case basis from among a pool of specialists determined to be qualified to hear a dispute? Would these specialists have the judicial temperament which is required of a judge? What if there were more than one specialized question in a dispute, would the hearing have to be bifurcated? Would the accounting court be limited to quantum, with entitlement to be determined by another court? Would the decision of this specialized court be appealable? If so, to which court? Would the appeals court have a proper record from a specialized court? Should the American Bar Association or the American Institute of Certified Public Accountants be the initiators of this court? These are but some of the questions raised by the proposal for an accounting court.

There are many arguments against an accounting court. For example, a system has already been established for handling accounting disputes, and this system evidently has been working well. It is a system where a judge is the decision maker. Judges have the training to create a proper record and the ability to make decisions. A judge also has the judicial temperament to allow the parties to develop their positions, and the judge is already familiar with due process. The parties can present expert accounting witnesses, if necessary, to create a record which will allow a judge to make the right decision. In addition, a judge can always appoint a special master to assist the court (F.R.E. 706). Furthermore, the judge has no preconceived ideas or opinions concerning the issues, hence, the judge's opinion should be objective. In most accounting disputes there are also legal issues (i.e., discovery, admissibility of evidence, etc.) which can only be decided by a judge. There may even be legal precedents which the judge may need to apply. If judges need to be familiar with generally accepted accounting principles, CAS, or DAR Section XV Cost Principles in order to decide an accounting issue, they could be required to take some formal training prior to being assigned to accounting cases. Just as not all accountants agree on the interpretation of generally accepted accounting principles or accounting terms, so also not all lawyers agree on interpretations of the law or legal terms. However, it is a relatively simple matter for the judge to get the parties to agree on the meaning of most terms, and to focus on the terms where they disagree as to meaning. If a specialist were to hear the dispute, there is the danger that the specialist will assume everyone agrees as to the meaning of key terms. Furthermore, the specialist may tend to have tunnel vision, rather than a broad objective view. Finally, a judge will often attempt to find some middle ground (compromise) between the parties, whereas a specialist may tend to look for the "right" answer.

However, there are stronger arguments which support an accounting court. For example, most attorneys do not understand generally accepted accounting principles, Cost Accounting Standards and the DAR Section XV Cost Principles. Therefore, the attorney spends much of his time educating himself before he can educate a judge. Even if the judge were not an attorney, perhaps it would be easier for accountants to learn legal procedures and rules of discovery than it is for a lawyer and a judge to learn accounting. The accountant can also be provided a legal advisor just as a judge can be provided a special accounting master. Because accountants and lawyers (judges) speak a different language, the judge requires an "interpreter." The accounting witness is used to translate the accounting terms into a language the judge understands. If the judge were an accountant, the interpreter would not be necessary, because the accountant would not need accounting witnesses to explain accounting principles and terms. Furthermore, the accountant could immediately focus on the accounting issue involved, rather than be sidetracked by terminology. This would help to expedite the hearing and to narrow the area covered in the attorneys' post-trial briefs. It would also reduce the litigation expense for those involved in accounting disputes. To those who are involved in Cost Accounting Standards and DAR Section XV Cost Principles disputes, an Accounting Court would be the welcome answer to the slow and expensive procedure now necessary for their resolution.

CONCLUSION

The single overriding prerequisite to satisfactory and expeditious decisions in accounting disputes is a judge with a thorough knowledge of accounting. It is essential that the judge have a working knowledge of commonly encountered accounting terms and accounting "terms of art."

The number of CAS disputes is growing and will continue to grow for at least the next several years in order to interpret the meaning of the various Cost Accounting Standards. The ASBCA decides many issues and provides many remedies under Government Procurement Law. However, purely accounting issues are not within its area of expertise and only multiply its already heavy workload. We need a more expeditious system for resolving CAS *and* DAR Section XV Cost Principles disputes.[11]

There are attorneys available with accounting degrees and accounting expertise. Some attorneys also are Certified Public Accountants (CPAs).[12] These are the type of individuals who would serve on the Accounting Court. They could be drawn both from within and without the Government, as were the members of the CAS Board. They could be appointed for a term of years, or, alternatively, they could be agreed to by the parties on a case-by-case basis. An Accounting Court composed of attorneys with expertise in accounting would significantly reduce the trial time for a CAS or Cost Principle case because many expert witnesses would not be required.[13] Additionally, accounting principles and concepts would not have to be reviewed in such detail during the trial and in the attorneys' post-trial briefs. Furthermore, decisions could be issued within a relatively short period of time. This is vitally important when one considers that the same CAS or Cost Principles question concerns many contractors, and delay in rendering a decision affects the pricing and costing, not only of the contractor involved in the dispute, but also of many other DOD contractors. As long as attorney-accountants decide these disputes, the Accounting Court can decide entitlement as well as quantum. The resulting savings of time and money will be beneficial to both sides. Finally, an Accounting Court's decision will be more readily acceptable, not only by the parties to the dispute, but by others affected as well. Additionally, the Accounting Court's decisions could be appealed to the Court of Claims, just as Boards of Contract Appeals decisions are appealable. The attorney-accountant can ensure that a proper record is made for any appeal. All the objections to an accounting court can be overcome by the appointment of attorney-accountants to the court. Therefore, Mr. Neuman's proposal for an Accounting Court is an idea whose time has come.

FOOTNOTES

[1] Neuman, "Auditing Rationale At Defense", (parts 1 and 2), *Government Executive*, May, June 1979.

[2] The DAR Council has a chairman and two members from each DOD agency, one legal and one contracting.

[3] Explanation of Principles for Determination of Costs Under Government Contracts, 1 April 1942.

[4] Treasury Decision 5,000 (Section 26.9) August 7, 1940.

[5] Civilian agencies within the Government are subject to the Federal Procurement Regulation (FPR). In many instances, revisions and changes to the DAR are subsequently adopted by the civilian agencies through the FPR.

[6] Either party may request the ASBCA to reconsider its decision in a case, but the moving party must set forth the specific reasons why it believes the Board should reconsider. If the Board agrees to reconsider, it will then affirm or reverse its prior decision.

[7] Where ambiguous contract language could result in two or more reasonable interpretations, the language will be interpreted most strongly against the party who drafted the contract or selected that language.

[8] *Appeal of McDonnell Douglas Corporation,* ASBCA No. 19842, 80-1 BCA¶ 14,223, *motion for reconsideration denied,* 80-2 BCA¶ 14,508.

[9] *The Boeing Company v. United States,* Court of Claims No. 268-79C.

[10] Leonard Spacek, *A Search for Fairness in Financial Reporting to the Public,* Chicago, Arthur Andersen & Co., 1969, p. 35.

[11] I would go one step further than Mr. Neuman and give the Accounting Court jurisdiction to determine DAR Section XV Cost Principles disputes.

[12] A former member of the CAS Board staff is an attorney, CPA and has a PhD in Accounting.

[13] This Accounting Court could even be a special division established within the ASBCA to decide only accounting disputes. The important point is that this Accounting Court be established with the recognition that these accounting cases require expeditious decisions because the issue normally affects all Government contractors.

DEFECTIVE PRICING

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OUTLINE

I. INTRODUCTION

II. TRUTH IN NEGOTIATIONS

A. Background

B. Truth in Negotiations Act

1. Purpose
2. Coverage
3. Cost or Pricing Data
4. Submission Requirements
5. Certification Requirements
6. Government Duty to Disclose
7. Subcontractors
8. Government Burden
9. Contractor Defenses
10. Government Recovery
11. Summary

I. INTRODUCTION

This section of the program will cover Defective Pricing, which is the "hottest" area in Government contracts today. The number of Defective Pricing allegations by the Government has increased significantly over the past year and will continue to increase for the foreseeable future because of the interest it has generated at the highest levels of Government. The Government alleges Defective Pricing when it believes that a contractor or subcontractor has not submitted its most accurate, complete and current cost or pricing data during negotiations.

II. TRUTH IN NEGOTIATIONS

A. Background

Congress has continuously been concerned that the Government has paid unreasonable prices, or that contractors have made excessive profits on negotiated contracts. Therefore, Congress has always preferred formal advertising over negotiated procurements. Thus, under present law, the Armed Services Procurement Act of 1947, as revised, requires DOD contracts for Supplies and Services to be formally advertised except under 17 specific situations where negotiations are allowable. The law covering non-DOD agencies is in the Federal Property and Administration Procedures Act of 1949, as amended (40 U.S.C. 471, et. seq.).

In 1951, as a result of this Congressional concern, the Comptroller General was given the right to audit DOD and Civilian Agency negotiated contracts. See, 10 U.S.C. §2313(b) which requires that each DOD negotiated contract:

> . . . provide that the Comptroller General and his representatives are entitled, until

> the expiration of three years after final payment, to examine any books, documents, papers, or records of the contractor . . . that directly pertain to, and involve transactions relating to, the contract. . .

In October 1959, the Armed Services Procurement Regulation (ASPR) (now entitled Defense Acquisition Regulation (DAR)) was revised to require contractors to provide a "Certificate of Current Pricing Data" during negotiations. It was clear by this time, Government procurement officials were at a disadvantage at the negotiating table in pricing out the evolving sophisticated technological weapons and improvements on old ones. The certificate was an effort to try to equalize the negotiation position of both parties. In January 1961, the ASPR was revised to add a Cost Reduction for Defective Pricing clause.

However, these regulatory provisions still did not satisfy Congress. Therefore, on 10 September 1962 it passed Public Law 87-653, 10 U.S.C. §2306(f), the Truth in Negotiations Act. Now, all contracts subject to the Act are required to have a Price Reduction for Defective Cost or Pricing Data clause [DAR Section

7-104.29], and a certificate, as soon as practicable after agreement is reached on price, that the Cost or Pricing Data provided to Government contract negotiators is accurate, complete and current [DAR Section 3-807.6].

In 1968, the Act was amended to provide for examination of records to determine whether a contractor had submitted accurate, complete and current data (Public Law 90-512).

Public Law 96-226 (April 3, 1980), 94 Stat 313, Section 102(c)(1) amended Section 313 of the Budget and Accounting Act, 1921 (31 U.S.C. §54) to provide:

> . . . the Comptroller General may require by subpena (sic) the production of books, records, correspondence, memoranda, papers, and documents of contractors, subcontractors, or other non-Federal persons to which he has access by law or by agreement of the non-Federal person [contractor] from whom access is sought. . . .

B. Truth in Negotiations Act

1. Purpose

The Truth in Negotiations Act (10 U.S.C. §2306)(f)), Public Law 87-653, imposes a duty on Government contractors to completely disclose cost and pricing information, and the information so disclosed must be, in the words of the Act, accurate, complete and current. M-R-S Manufacturing Co. v. United States, 203 Ct.Cl. 551, 492 F.2d 835 (1974); Sylvania Electric Products, Inc. v. United States, 202 Ct.Cl. 16, 479 F.2d 1342 (1973); Lockheed Aircraft Corporation v. United States, 193 Ct.Cl. 86, 432 F.2d 801 (1970); Cutler-Hammer, Inc. v. United States, 189 Ct.Cl. 76, 416 F.2d 1306 (1969). The purpose of the Act is to avoid excessive contract costs that result from a contractor having in its possession, accurate, complete and current information when the Government does not possess the same data, and the only way to further the purpose of the Act is to require a complete disclosure of cost or pricing data known to the contractor. M-R-S Manufacturing Co., supra; Sylvania Electric Products, Inc., supra. As the Court of Claims explained in Sylvania, supra:

> If the Truth in Negotiations Act is to have any force and effect then the Government must be clearly and fully informed. This can only be achieved by complete disclosure . . . (202 Ct.Cl. at 26, 479 F.2d at 1348)

2. Coverage

The Truth in Negotiations Act makes the cost or pricing data submissions mandatory for negotiated prime contracts and subcontracts under such contracts where the price is over $500,000. The Act also requires prime and subcontractors "to certify that, to the best of his knowledge and belief, the cost or pricing data he submitted was accurate, complete and current" as of a specified date.

Although certification is not required for contracts below $25,000, *it may* be required for modifications below $25,000 but generally will not be requested. However, the contracting officer is authorized to request partial data, without certification. (Note: This $25,000 threshold may be increased for DOD contracts by the DAR Council in the near future and the DAR accordingly amended.)

Certification *may* be required for contracts and modifications between $25,000 and $500,000 but should only be requested in a relatively few instances.

Certification is required for all contracts and modifications over $500,000. (Note: For subcontractors, the prime and higher tier subcontractors must have been required to furnish certified data.)

See, DAR §3-807.3(d); FPR §1-3.807-3(g)(1).

However, the Act also exempts otherwise covered contracts if one of the following four conditions is met:

(1) Adequate price competition (DAR §3-807.7(a)(1)); FPR 1-3.807-1(b)(1)).

(2) Established catalog or market prices (DAR §3-807.7(b)(1)).

(3) Prices set by law or regulation (not covered in the regulations).

(4) Agency head waivers (DAR §3-807.3(b); FPR §1-3.807-3(a)).

3. Cost or Pricing Data

DAR §3-807.1(a)(1) (FPR §1-3.807-3(h)) provides:

> Cost or pricing data consists of all facts existing up to the time of agreement on price which prudent buyers and sellers would reasonably expect to have a significant

effect on price negotiations. Cost or pricing data embraces more than historical accounting data. It also includes such factors as all vendor quotations, nonrecurring costs, changes in production methods and production or procurement volume, data in support of contractor projections of business prospects and objectives, together with related costs of operations, unit cost trends such as those associated with labor efficiency, make-or-buy decisions and estimated resources to attain business goals and any other management decisions which reasonably could be expected to have a significant bearing on costs under a proposed contract, *e.g.*, the comparative analysis by which a particular vendor was selected. In short, cost or pricing data consist of all facts which reasonably can be expected to contribute to sound estimates of future costs as well as to the validity of costs already incurred. Cost or pricing data, being factual, are that type of information which can be verified.

DAR §3-807.6 (FPR § 1-3.807-4) provides:

(a) When a Certificate of Current Cost or Pricing Data is required, the certificate set forth below shall be included in the contract file along with the memorandum of the negotiation, see 3-811. The contractor shall be required to submit only one certificate which shall be submitted as soon as practicable after agreement is reached on the contract or modification price.

CERTIFICATE OF CURRENT COST OR PRICING DATA

This is to certify that, to the best of my knowledge and belief, cost or pricing data as defined in DAR 3-807.1(a)(1) submitted, either actually or by specific identification in writing (see DAR 3-807.3(a)) to the Contracting Officer or his representative in support of ....* are accurate, complete, and current as of (day) (month) (year).............**

This certification includes the cost or pricing data supporting any advance agreement(s) and forward pricing rate agreements between the offeror and the Government which are part of the proposal.

Firm......................
Name......................
Title.....................
Date of Execution...........***

(End of certificate)

*Describe the proposal, quotation, request for price adjustment or other submission involved, giving appropriate identifying number (e.g., RFP No........)

**The effective date shall be the date when price negotiations were concluded and the contract price was agreed to. The responsibility of the contractor is not limited by the personal knowledge of the contractor's negotiator if the contractor had information reasonably available, at the time of agreement, showing that the negotiated price is not based on accurate, complete and current data.

***This date should be as close as practicable to the date when the price negotiations were concluded and the contract price was agreed to.

(b) Because the certicate pertains to "cost or pricing data," it does not make representations as to the accuracy of the contractor's judgment on the estimated

> portion of future costs or projections. It does, however, apply to the data upon which the contractor's judgment is based. This distinction between fact and judgment should be clearly understood.
>
> (c) Whenever a Certificate of Current Cost or Pricing Data is required, the applicable clause in 7-104.29 shall be included in the contract.

The definition of cost or pricing data makes it clear that all "facts" which reasonably could be expected to have a significant bearing on costs under the proposed contract must be disclosed to the Government. Sometimes, however, there is a problem distinguishing "facts" from "estimates." However, in Hardie-Tynes Manufacturing Co., ASBCA No. 20717, 76-2 BCA ¶12,121. The Board stated:

> . . . [Appellant] was obliged to make available to the Government all facts which reasonably could be expected "to have a significant effect on the price negotiations." The Government was entitled to such information so it could independently determine the reasonableness of appellant's estimates. . . . Although pure estimates are not "cost and pricing data" the facts reasonably relating thereto most assuredly are. . . . (at 58,227)

In American Bosch Arma Corporation, ASBCA No. 10305, 65-2 BCA ¶5280, the Board cited correspondence between GAO and DOD which pointed out that negotiation of price is based largely on two things:

> [F]irst, past cost experience, and second, forecasts of what it will cost to perform in the future. The first is factual and should be based on cost and pricing data that is current, complete and accurate. The second is essentially a matter of applying judgment to the possibility of various contingencies occurring; and it depends, not only on cost trends and projections based on past costs, but also on how risks should be assessed and distributed, which calls for judgment outside the normal sphere of accountants and auditors on matters that cut across individual cost elements and may be entirely unrelated to any specific cost element. DOD does not expect its negotiators to agree with the contractor's forecast, nor he with theirs, but rather that both forecasts will be founded on the same factual basis and that both parties will bargain with the understanding that the total of all forecasts is a sum of possibilities--not certainties--and that compromise of extremes may be necessary to a fair settlement. (at 24,847)

4. Submission Requirements

The DAR test as to which data must be submitted is whether "prudent buyers and sellers would reasonably expect" the data "to have a significant effect on price negotiations." (DAR 3-807.1(a)(1))

In M-R-S Manufacturing Co., supra, the Court of Claims concluded:

> . . . [I]f a contractor possesses accurate, complete, and current information that is relevant to negotiations with the Government, and he neither physically delivers the data to the Government, nor makes the Government aware of the information's significance to the negotiation process, then he has not fulfilled his duty under the Act to furnish such information to the Government.

These "prudent man" and "relevant to negotiations" tests are still subjective. In Sylvania Electric Products, Inc. v. United States, 202 Ct. Cl. 16, 479 F.2d 1342 (1973) the Court said:

> In general, as to all the above items, plaintiff has argued that mere submission of data satisfied the requirement of disclosure. We do not agree. In order that there be effective disclosure of cost and pricing data by the prospective contractor the Government must be clearly advised of the relevant cost and pricing data. This is particularly true after the Government has analyzed the data and the contractor then receives reduced quotations from its suppliers.
>
> If the Truth in Negotiations Act is to have any force and effect then the Government must be clearly and fully informed. This can only be achieved by complete disclosure of the item or items in question. (479 F.2d at 1348)

Finally, in Singer Company, Librascope Division v. United States, 217 Ct.Cl. 225, 576 F.2d 905 (1978) the Court said:

> . . . [T]he plaintiff's duty to disclose remains the same whether he chooses to disclose to the negotiator or to some other appropriate Government employee. What the plaintiff must do is physically deliver the information to the Government and make the information's significance to the negotiation process known. (576 F.2d at 914)

There is no obligation to submit data obtained after the close of price negotiations. Paceco, Inc., ASBCA No. 16458, 73-2 BCA ¶10,119; Conrac Corporation, ASBCA No. 15964, 74-1 BCA ¶10,605, at 50,292.

5. Certification Requirements

Only one certificate need be submitted and it "should be as close as practical to the date when the price negotiations were concluded and the contract price was agreed to." The effective date of the certificate is the "shake hands" date.

A certificate is required by the Act, and the DAR requires it for contracts over $500,000. Despite these requirements, the ASBCA has held that any allegation of defective pricing is dependent on obtaining the required certificate because the Price Reduction clause provides that the reduction is tied directly to the certificate. Libby Welding Co., ASBCA No. 15084, 73-1 BCA ¶9859; Lockheed Shipbuilding & Construction Co., ASBCA No. 16494, 73-2 BCA ¶10,157; Aerojet General Corp., ASBCA No. 12873, 69-1 BCA ¶7585.

However, these cases appear to be inconsistent with the Court of Claims' emphasis in M-R-S Manufacturing Co., supra, on the statutory requirements and the purpose of the Act. Furthermore, a federal District Court judge interpreting M-R-S in an unpublished decision stated, as dictum, that the Government is entitled to a price reduction even where neither data nor a certificate had been furnished by the contractor. United States v. Newport News Shipbuilding & Dry Dock Co., Civ. No. 75-88NN (E.D. Va. March 8, 1977). The involvement of high level corporate and Navy personnel may have affected the court's thinking under the particular factual setting.

6. Government Duty to Disclose

DAR §3-807.10(b) [FPR 1-3.3.807-5(b)] provides:

> If at any time prior to agreement on price, the contracting officer learns through audit or otherwise that any cost or pricing data submitted are inaccurate, incomplete, or non-current, he shall immediately call it to the attention of the contractor whether that defective data tends to increase or decrease the contract price. Therefore, the contracting officer shall negotiate on the basis of any new data submitted, or on a basis which makes satisfactory allowance for the incorrect data, and shall reflect these facts in his record of negotiation.

In essence, the contracting officer's duty to disclose here is analogous to the duty to notify a contractor of an obvious mistake in bid.

7. Subcontractors

All prime contractors who have to furnish cost or pricing data must require cost or pricing data from their subcontractors where the subcontract price is $1 million or more, or where the subcontract price is $500,000 or more if also more than 10% of the prime's proposed price (subject to the same exceptions as apply to prime contracts) (DAR 3-807.4(a)). Other subcontractors "may" be required to furnish cost or pricing data. DAR 3-807.4(b) requires that prospective subcontractor data be accurate, complete and current as of the same date specified in the contractor's certificate (date of "hand shake" between the prime and the Government). Therefore, the prime should require the sub to update its proposals during the prime's negotiations with the Government.

If defective data has been submitted by the sub, then the prime will be liable to the Government, even if it had no knowledge of the sub's defective data (DAR 3-807.10(d)(2)).

The sub is liable to the prime (not to the Government). Therefore the prime's contract with the sub should contain an indemnification clause. Normally, the sub and the prime also have an agreement that the prime will allow the sub to appeal a contracting officer's defective pricing allegation to the Board or Court in the name of the prime.

The Subcontractor Cost or Pricing Data clause is found in DAR §7-104.42(a) [FPR §1-3.814-3(a)], and the Audit by Department of Defense clause is found in DAR §7-104.41.

8. Government Burden

In order to recover in a defective pricing claim, the Government must prove:

a. Certification.

b. The defect is cost or pricing data.

c. Data reasonably available to the contractor.

d. Government not advised of relevant data and lack of knowledge.

e. Reliance by the Government on inaccurate and incomplete data.

f. Incomplete/inaccurate data caused an increase in the contract price. (Would a lower price have been negotiated if the Government had knowledge of the complete/accurate data?)

In Sylvania Electric Products, Inc., supra, the Court stated the rule that the Government has the burden of proving nondisclosure or use of inaccurate and noncurrent data. However, it also stated that once this burden has been satisified, it was a natural and probable consequence that such nondisclosure would result in an overstated negotiated contract price.

Therefore, once the Government meets its burden of proof, the contractor has the burden of persuasion that the Government did not rely on the data.

DAR §3-807.10(a)(2) states that in the absence of evidence to the contrary (data not used or relied upon), the natural and probable consequence of defective data is an increase in the contract price in the amount of the defect, plus related burden and profit. Therefore, once the Government shows that the data was defective, the burden of persuasion is on the contractor, both as to reliance and causation, to rebut the presumption.

9. Contractor Defenses

a. No certificate.

b. Not cost or pricing data.

c. Data not reasonably available before agreement on price.

d. Government was aware of the data or it was submitted.

e. Government did not rely on the data.

f. No impact on price.

g. Setoffs.

DAR §3-807.10(a)(3) provides:

> In determining the amount of an adjustment, the contracting officer shall consider any understated cost or pricing data submitted in support of price negotiations for the same pricing action (e.g., for the initial pricing of the same contract or for pricing the same change order), up to the amount of the Government's claim for overstated cost or pricing data arising out of the same pricing action. Such offsets, however, need not be in the same cost groupings (e.g., material, labor or overhead).

As the Court of Claims stated in Lockheed Aircraft Corporation v. United States, 193 Ct.Cl. 83, 432 F.2d 801, 807 (1970):

> The allowance of offsets does not give the contractor a windfall, nor does it penalize the Government. In both the Cutler-Hammer situation and the one which prevails here, allowing offsets according to our formula merely allows the setting of the negotiated price in an amount which reflects the true costs. If overstatements exceed understatements, the Government is still allowed to reduce the contract price by the amount of the excess. No raising of the price is allowed, however.

Errors in judgments, as distinguished from factual data, provide no basis for setoffs, Norris Industries, Inc., ASBCA No. 15442, 74-1 BCA ¶10,482, at 49,581, and a change in prices after agreement on price is not a valid setoff either. Furthermore, a conscious management decision to exclude data from a price proposal cannot be claimed as a setoff, but the Government has the burden of proving the omission was intentional. Lockheed Aircraft Corporation, 485 F.2d 584 (Ct.Cl. 1973). However, an inadvertent exclusion is a valid setoff. Libby Welding, supra.

Setoffs between contracts are not permitted. Minnesota Mining and Manufacturing Co., ASBCA No. 20266, 77-2 BCA ¶12,823; Norris Industries, Inc., supra.

A contractor has the burden of proving setoffs and their effect on price. Libby Welding, supra.

10. Government's Recovery

In American Bosch Arma Corporation, ASBCA No. 10305, 65-2 BCA ¶5280 the Board adopted the "natural and probable consequence" rule where there is a dollar-for-dollar reduction in the contract price equal to the amount of the defective pricing data (plus related burden or profit). The Board stated:

> In the absence of any more specific evidence tending to show what effect the nondisclosure of the pricing data had on the negotiated target cost, we are of the opinion that we should adopt the natural and probable consequence of the nondisclosure as representing its effect. Theoretically the nondisclosure of pricing data showing a price reduction of $20,746 should have resulted in a reduction in the negotiated target cost of $20,746 for materials cost plus a G&A allowance of 9.23%, making a total of $22,661. That is deemed to be the natural and probable consequence, and there is nothing in the record to indicate that its effect was otherwise. Accordingly, we held that the nondisclosure of significant and reasonably available cost and pricing data caused the negotiated target price to be overstated in the sum of $22,661. (at 24,853)

In Aerojet-General Corp., ASBCA No. 12264, 70-1 BCA ¶8140 (affirming its ealier decision in 69-1 BCA ¶7664) the Board, citing American Bosch Arma Corp., supra, reaffirmed its "natural and probable consequence" rule in the absence of more specific evidence to the contrary. (Note: In this case the Board found that Aerojet knew that the sub's quote was overstated and failed to inform the Government during negotiations on the prime contract.)

The DAR §3-807.10(a)(2) [FPR §1-3.807-5(a)(2)] also states the "natural and probable consequence" rule that there will be a dollar-for-dollar decrease in the contract price in the amount of the defect plus related burden and profit or fee, in the absence of evidence to the contrary.

In Sylvania Electric Products, Inc. v. United States, 202 Ct.Cl. 16, 27, 28, 479 F.2d 1342, 1349 (1973), the Court, citing the Board's American Bosch case, adopted the "natural and probable consequence" rule when it said that once the Government had satisfied its initial burden of proof it was the natural and probable consequence that such nondisclosure would result in an overstated negotiated contract price. The Court went on to state:

> . . . This is a logical presumption, for it is reasonable to assume that the government negotiators relied upon the data supplied by the contractor and that this data affected the negotiations.
>
> Thus although the Government has the burden of proof as to the issue of nondisclosed data, which it met in this case, the burden of persuasion on the issue of relying upon that data has shifted to the contractor. He must show nonreliance on

> behalf of the Government in order to rebut the natural and probable consequences of the existence of the nondisclosed or inaccurate data.[7] This the contractor has not done in this case. Accordingly the presumption stands and there was a causal relationship between the disputed data and the final negotiated price.

Footnote 7 states that this presumption has been codified by its adoption in the ASPR and cited 32 CFR §3-807.5(a)(2).

However, there were also a few other cases where the Board arrived at a compromise. For example, in Bell & Howell Co., ASBCA No. 11999, 68-1 BCA ¶6993, the Board concluded that if the Government had been aware of the defective data the parties would not have negotiated a contract. Therefore, the Board assumed that the effect of the nondisclosure on the price was proportionate to the relationship between the final price and the parties' initial negotiation objectives. In Aerojet-General, ASBCA No. 12873, 69-1 BCA ¶7585, the Board used the same compromise percentage used by the parties in negotiating a final price. It directed the parties to recompute the negotiated target cost by use of the same compromise percentage, and to make the requisite change to the target profit to arrive at a revised target price.

In American Machine & Foundry Co., ASBCA No. 15037, 74-1 BCA ¶10,409, the Board held that the Government was not entitled to a price reduction for a contractor's failure to disclose that it had obtained a component bid price lower than the price quoted to the Government because the Government failed to prove any difference between the total contract price and the price that would have been agreed upon had the Government known of the lower bid.

11. Summary

Defective pricing can best be summarized by quoting the ASBCA in American Machine & Foundry, supra, when it stated:

> This case illustrates the considerable amount of speculation that is frequently encountered in considering a so-called defective pricing case, whether the eventual decision is in favor of the contractor or in favor of the Government. However, engaging in a certain amount of speculation is often required if the Board is to reach a conclusion in a defective pricing case as to what the agreed price would have been if the contractor had adequately disclosed the disputed cost and pricing data to the

> Government. Reaching such a conclusion is necessary because only by reaching such a conclusion, despite all the "ifs" and "buts" involved, can the Board in appropriate cases lay a foundation upon which to base a direction to the contracting officer to leave in effect, to change the amount of, or to eliminate a reduction in the contract price previously demanded by the contracting officer, in accordance with the primary objective of the Truth-in-Negotiations Act. Such speculation is necessary because, manifestly, there is no way to know for certain at a later time what might have happened at a substantially earlier time--often some years ago--if conditions had been somewhat different.
>
> In resolving a defective pricing dispute the Board attempts to weigh all the possibilities presented by the record which appear to be worthy of such attention, ultimately selecting that possibility which is the most reasonable in the light of all the circumstances of record. The process is less difficult to follow than to describe in words, not too unlike the situation said to exist between the process of selecting the winner of a beauty contest and in describing the process one used in making such a selection. The more facts of record one has available to ponder the better the position one should be in to make a fair and just decision in a defective pricing case, particularly in view of the conjecture and speculation to which resort must eventually be had. That is why we have set forth hereinbefore more factual detail, perhaps, than we would in some other type of case. (at 49,181)

Chairman ROTH. The committee is in recess.

[Whereupon, at 12:10 p.m. the committee was adjourned, subject to the call of the Chair.]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

WILLIAM V. ROTH, JR., DEL., CHAIRMAN

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United States Senate
COMMITTEE ON
GOVERNMENTAL AFFAIRS
WASHINGTON, D.C. 20510

June 8, 1983

The Honorable Caspar W. Weinberger
Secretary of Defense
Room 3E880
The Pentagon
Washington, D. C. 20301

Dear Cap:

On April 14th, the Committee on Governmental Affairs conducted the second in its series of Defense Department oversight hearings to be held this year.

In this "defective pricing" hearing, we examined the effectiveness of Defense Department actions regarding the disclosure and resolution of Truth in Negotiations Act (Public Law 87-653) violations. The following five Defense Department witnesses provided statements and responded to questions:

- Mr. Harvey J. Gordon, Assistant Deputy Under Secretary for Acquisition
- Mr. Charles O. Starrett, Jr., Director, Defense Contract Audit Agency
- Mr. Derek J. Vander Schaaf, Acting Deputy Inspector General, Department of Defense
- Judge Harris J. Andrews, Chairman, Armed Services Board of Contract Appeals
- Mr. Donald J. Kinlin, Senior Trial Attorney, Department of the Air Force

These officials offered very informative and, in some instances, divergent views on virtually every important aspect of the issue. Collectively, their testimony identified several actions that need to be taken to fully restore the original intent of the law and the effectiveness of its application to negotiated Defense contracts.

I am currently drafting legislation, based on the testimony offered before my Committee, to clarify and strengthen Public Law 87-653. In the meantime, I have enclosed a list of Defense Department actions that incorporates the major improvements in

The Honorable Caspar Weinberger
June 8, 1983
Page 2

the implementation of the defective pricing law suggested at the hearing. These recommendations can be taken by the Defense Department independently of future amendments to the law and I request that you carefully consider adopting them.

I know you are aware that I strongly support the Administration's objective to prudently rebuild the nation's defense forces. I also believe that you strongly support one of the objectives of the oversight hearings in my Committee-- to demonstrate that the Pentagon can spend its rapidly increasing budget effectively.

I suggest that the Defense Department seriously review and consider implementing the proposed actions attached to this letter either by assigning them directly to the cognizant Defense officials or by incorporating them into the existing Defense acquisition policies. I am convinced that improvements can be made in the implementation of the defective pricing law and I believe the enclosed suggestions merit careful attention. I would appreciate your advising me of Defense Department actions on them.

Please express my appreciaton to Judge Andrews and Messrs. Gordon, Starrett, Vander Schaaf and Kinlin for their participation in the Committee hearing. I look forward to hearing from you in the near future.

Sincerely,

Bill Roth

William V. Roth, Jr.
Chairman

WVR:smh

Enclosure

Actions That Can Improve The Effectiveness of The Defense Acquisition Process And Reduce Related Wasteful Practices (As Disclosed in Defective Pricing Hearing)

I. Under Secretary of Defense Research and Engineering

A. Changes in DoD Acquisition Policies

1. In Defense Acquisition Regulation (DAR) 7-104.29, Price Reduction for Defective Cost or Pricing Data and 3-807.3, Requirement for Cost or Pricing Data, reduce the threshold amount for certification from $500,000 to $100,000 for contractor cost or pricing data.

2. In DAR 3-807.4, Subcontractor Cost or Pricing Data, reduce the threshold amount for certification from $500,000 to $100,000 for subcontract cost or pricing data.

3. In DAR 3-801.5(b), Field Pricing Reports on Contract Pricing Proposals, return the threshold amount from $500,000 to $100,000 for firm-fixed-price proposals and to $250,000 for fixed-price incentive proposals.

B. Strengthening of DoD Acquisition Policies

1. In DAR 3-811, Record of Price Negotiation, expand the requirement for sufficient detail of factors considered in establishing negotiated price (i) to include the identification and description of each significant factor not reflected in the contractor's or subcontractor's original pricing proposal but submitted subsequently in the price negotiations process and (ii) to state the specific extent, if any, that the factor influenced individual elements of cost and negotiated price.

2. In DAR 3-812, Disposition of Post Award Audits, expand the guidance on DCAA defective pricing reviews to require contracting officers (i) to report their position and related action on every cost or pricing data element questioned by the auditor and (ii) to explain the settlement rationale for each questioned cost or pricing element on which the contracting officer's position or settlement basis was lower than the questioned amount.

C. Emphasizing DoD Acquisition Policies

1. Issue a Defense Acquisition Circular immediately to advise contracting officers of the forthcoming changes to DAR 7-104.29, 3-807.3 and 3-807.4 lowering (i) the

certification threshold for cost or pricing data back down to $100,000 and the threshold for mandatory pre-award audits back down to $100,000 for firm-fixed-price proposals and to $250,000 for fixed-price incentive proposals.

2. Issue a Defense Acquisition Circular instructing contracting officers (i) to be alert for negotiation conditions that are conducive to defective pricing violations and (ii) to notify DCAA of such conditions when considered appropriate.

II. Department of Defense Inspector General

A. Changes in DoD Audit Policies

1. Through a DoD contract audit policy issuance, emphasize the importance of providing a greater proportion of DCAA audit resources to post-award defective pricing reviews and direct that some of this increased effort be applied to subcontractor defective pricing violations.
2. Establish a DoD audit policy (i) prescribing guidance to DCAA concerning the selection, scope and depth of defective pricing audits, including a requirement to incorporate fraud-oriented audit steps in these post-award contract audits, and (ii) requiring that limitations in audit scope, such as a concentration of audit effort on material or some other cost element, be clearly stated in the DCAA report on defective pricing reviews.
3. Institute a procedure for reporting major DCAA auditor-contracting officer disagreements to the DoD IG.

B. Emphasizing Related DoD IG and Military Service Internal Audit Oversight Activities

1. The DoD IG should increase the oversight activities of DCAA operations relating to:
    a. The selection, scope and depth of post-award defective pricing reviews.
    b. The nature and extent of the DCAA auditor's communications with contracting officers prior to and in the course of defective pricing audits.
    c. The adequacy of the DCAA auditor's analysis of the contracting officer's procurement negotiation

memorandums required by DAR 3-811 and their memorandums on defective pricing settlements required by DAR 3-812.

2. The DoD IG oversight activities of Army, Navy and Air Force internal auditor's reviews should be increased, relating to the contracting officer's activities (i) in negotiating original contract prices and contract modifications requiring certification of cost or pricing data and (ii) in settling defective pricing cases.

C. Tracking the Resolution and Action on DCAA Defective Pricing Reports

Fully implement the DoD Directive 7640.2 tracking and semi-annual status reporting requirements for outstanding DCAA defective pricing reports.

III. Director, Defense Contract Audit Agency

A. Improving Audit Planning Activities

1. Revise audit priorities to increase proportion of audit resources applied to post-award defective pricing reviews.

2. Reexamine the DCAA criteria for selecting contracts for defective pricing reviews to be sure that these efforts are directed at contracts and subcontracts with the greatest likelihood of defective pricing violations and do not without due consideration exclude from their scope significant cost or pricing elements.

3. Expand the DCAA audit guidance to increase auditor awareness of potential fraud situations in the course of performing post-award defective pricing reviews.

B. Increasing the Usefulness of Contracting Officers' Negotiation Memorandums

1. Emphasize to all DCAA auditors the need to analyze and appraise the contracting officer's procurement negotiation memorandums (DAR 3-811) and their memorandums of settlements of defective pricing cases (DAR 3-812).

2. Instruct all DCAA officials to be sure that periodic follow-up inquiry is made so that DCAA promptly receives copies of the negotiation and settlement memorandums prescribed in DAR 3-811 and 3-812.

○